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**Tim Koogle,
President
& CEO**

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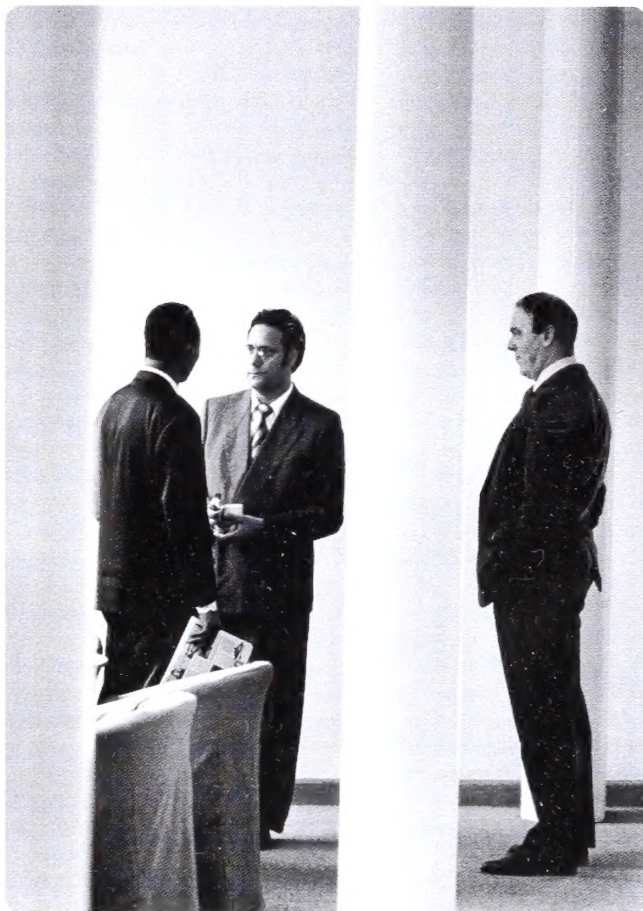
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A close-up photograph of a person's chest wearing a black t-shirt. The word "YAHOO!" is printed across the chest in large, bold, yellow capital letters with a thick red outline. The person's chin and neck are visible at the top of the frame.

The Company, The Strategy, The Stock

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WORK THE WEB™



THE CEO, THE TOADY and the sycophant.

They stood around the table staring at a copy of *The Wall Street Journal* as if it emanated a fetid smell of sulfur. What happened? The CEO asked, pointing to the newspaper. We should be featured in that article. We're the leaders. I'm sick to my stomach from reading about them. Now they beat us on another proposal. A silence followed, deafening the darkened conference room except for the white noise of stale air circulating. How did they ¹(find the right people to pull it together so quickly)? Their designers are in San Diego. The finance group's in New York. Manufacturing's in Malaysia. Look people, we've got to get our teams to ²(collaborate better, faster). As Pogo said, I have seen the enemy and he is us. Is it their network? Their systems? We just don't have the ³(advanced technology), the Product Manager said. Well, get the people. Get the ⁴(tools). And get it done. The sycophant's eyes brightened. He raised his nose slightly, as if he smelled blood, opportunity or both. I think you're absolutely right, sir, he said, I've felt this way for at least six months now.

THE ⁵(BEST PARTS) OF HIS COMPETITOR'S DAY WERE MADE POSSIBLE BY LOTUS.

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BusinessWeek

SEPTEMBER 7, 1998

Cover Story

66 YAHOO!

In just three years, Yahoo! Inc. has morphed from an ordinary search service into the Net's be-all and do-all, offering a dizzying array of information. Today, the stock is 23 times its 1996 IPO price, and Yahoo is the lord of the Web. The company's marketing machine is pumping hard to gain and hold users, but powerful competitors are moving into the portals business fast. Can Yahoo keep clicking?

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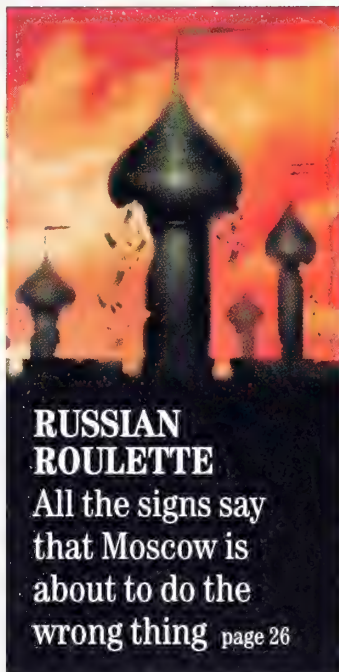


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Up Front

EDITED BY ROBERT McNATT

PRODUCT PEEK

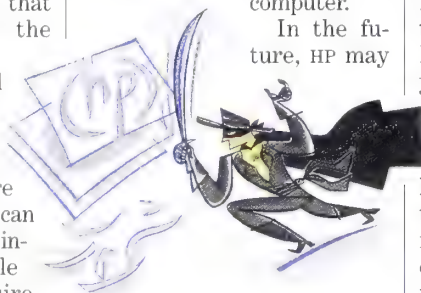
WILL HP's ZORRO LEAVE ITS MARK?

IN SEPTEMBER, TECHNOPHILES will see the results of one of Hewlett-Packard's boldest efforts yet when it introduces an easy-to-use handheld scanner, code-named Zorro, that scans documents with the wave of an arm.

This little technical marvel, BUSINESS WEEK has learned, will cost under \$1,000. It will boast the ability to store up to 50 images, which can be downloaded, says an industry consultant. While current scanners require users to adhere to strict rules to get a clear image, a special HP chip and slick software algorithms let Zorro take 75,000 pictures per second. That way, the device can offset the effects of random arm movements.

The unit will also likely feature Hewlett-Packard's Jet-Send software, so documents can be sent to compatible printers and other gizmos, rather than only to a PC. That way, for instance, a teacher could scan homework assignments and print them out without logging on to a computer.

In the future, HP may



follow Zorro with a wireless version, so users could zip articles to friends right from their living rooms, and even a small printer, which could print as it moved across the page, says HP Labs chief Joel Birnbaum. *Peter Burrows*

AFTERLIVES

THE WATCH ISN'T REALLY GOLD, EITHER

YEAR AFTER YEAR, SEAGATE technology basked in the glow of its quirky founder, Al Shugart, who ran the disk-drive company and once ran his dog, Ernest, for Congress. But in July, Seagate fired Shugart, he says, amidst an industry downturn. And his severance package is not going to trigger much envy among the conspicuously wealthy of Silicon Valley.

Shugart will get his \$750,000 salary for three years, says Seagate's proxy. But the company gives him only three years to exercise his remaining stock op-

tions, rather than the full amount of time remaining on them. One plum, however: Shugart kept 145,000 shares of restricted stock—worth about \$3.6 million—that Seagate likely could have held on to, says Graef Crystal, a comp expert. Overall, Crystal describes the package as “pretty conservative.” Seagate declined comment.

Life after Seagate? Shugart is mulling a return to some type of high-tech business. And he is expected to join the board of Cypress Semiconductor. He is also working with Michael Ovitz to bring back an NFL team to Los Angeles. Says Shugart of his ouster: “Life goes on. I'm not going to crawl into a cave or anything.”

Peter Burrows



SHUGART: “Life goes on”

TALK SHOW “Our responsibility, we believe, is to give you the widest possible array of payment options.”

—Steve Holden, national electronic program director at the IRS, which will begin accepting credit card payments next year

BANK NOTES

SIDELINING SANDY FOR A WHILE?

IT HAS BEEN ALMOST THREE decades since Sandy Robertson launched his high-tech investment bank Robertson, Stephens & Co. Now that its corporate parent, BankAmerica, is set to sell the unit to BankBoston, the 67-year-old industry veteran wants to start another firm.

There's just one hitch. And it could turn out to be a costly one for BankAmerica. A condition of the \$800 million sale, expected to close on Sept. 1, is that Robertson won't work in investment banking for at least a year. A banking

source says that if Robertson violates the noncompete agreement, BankAmerica would have to pay a penalty to BankBoston, possibly in excess of \$75 million.

Both Robertson and BankAmerica decline comment. But the dispute, say sources, has been particularly uncomfortable for BankAmerica Chief Executive David Coulter, a longtime friend of Robertson. So the two men, with their lawyers, have been working hard to reach a solution. Another source says they are



ROBERTSON: \$75 million?

nally close to a deal that would pay Robertson several million dollars—but would also keep him out of the banking business for at least a year. *Linda Himmelstein*

THE DEAL MILL

WELCOME TO THE VIRTUAL IVY LEAGUE

THE NATION'S TOP BUSINESS schools have long scoffed at the idea that they could teach capitalism's secrets without a live, pipe-smoking professor in front of the class. No longer. Instead of denigrating companies that offer Internet-based courses, elite institutions such as Harvard business school are investing in them.

The object of Harvard's desire is two-year-old Pensare Inc., a Los Altos (Calif.) startup that will develop online business courses with the school's publishing arm. Pensare is also working with the Wharton School on executive education courses. Pensare CEO Doug Donzelli says he would eventually like to offer an online MBA to corporate employees. Harvard Business School Publishing is so impressed that, for the first time, it has chosen to receive stock options as partial payment. It hopes to cash in if Pensare, a



business education software firm, goes public.

Pensare's technology is also part of Wharton's first distance-learning course, “Building a Business Case,” which starts Sept. 10. Why pick a tiny startup over better-funded rivals such as Michael Milken's Knowledge Universe? Wharton believes Pensare's user-friendly approach makes online learning exciting. It's not just tweedy in-the-flesh pros who can be gull. *Jennifer Reingold*



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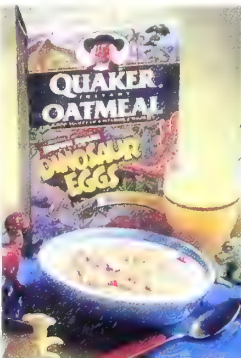
Up Front

PRODUCT PEEK

T-REX IS FOR KIDS

WHAT'S FOR BREAKFAST, Mom? How 'bout a nice hot bowl of reconstituted dinosaurs? No, they are not a spin-off from some Steven Spielberg opus. Courtesy of Quaker Oats, these dinos are ingredients in a new cereal: Dinosaur Eggs Instant Oatmeal.

O.K., so it's not made with real dino eggs. But although parents may gag at the idea, Quaker is betting kids will get a kick out of seeing a sugary T-rex "hatch" during breakfast. Just add hot water, and "eggs" in the brown sugar oatmeal will melt away to reveal tiny edible dinos. Says



JURASSIC: *Dino fun*

Bruce Poole, business director for Quaker Oatmeal, "we hope this strengthens the presence of fun in the bowl."

This isn't the first time a company has sought to make a cereal killing through oatmeal transfiguration. In 1991, General Mills tried—and then withdrew—Under Cover Bears, an instant oatmeal that yielded candylike little bears. Marketing expert George Carey of Just Kid Inc. warns Dino Eggs may face a similar fate: "The interactive play value of the cereal can get old pretty quickly." So Quaker is already developing new ways to hatch the "eggs" and new breeds of hatchlings. "Our challenge will be to keep it new," Poole says. Or face extinction. *Ellen Neuborne*

GREEN WATCH

THE DAYS OF SWINE AND ROSES

LIVING NEAR A PIGSTY is tough on the nose. As metro areas expand, once remote hog farms edge ever closer to residential tracts. So now farmers have to deal with air and water quality issues, and, yes, the stench of tons of pig manure.

Science to the rescue. The National Pork Producers Council, trade group for the \$13 billion industry, along with 17 farm state universities, has been working for a year on ways to reduce farm smells under the aptly named "Odor Solutions Initiative." So far, promising approaches include feed additives that reduce the smell of pig waste.

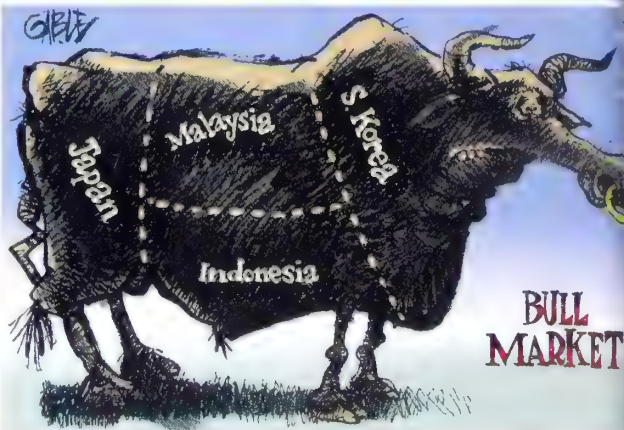
But the newest method is



a specially designed straw screen. It's now being tested at the 5,000-sow Enviropork, a privately owned cooperative near Larimore, N.D. In August, Enviropork installed the experimental screens, designed to catch

odors before exhaust fans suck the air from the barns. This is in addition to straw-treated with enzymes to speed up the breakdown of manure—that cover a sewage lagoon. Enviropork officials, under court order to fix a variety of environmental ills, contend that the result is so effective that the neighbors would never raise a stink. *Dennis Blank*

DRAWN & QUARTERED



I-WAY PATROL

FIGHTING PIRATES? SING TO 'EM

BILL GATES, SONGWRITER? Almost. With pirated software rampant in China, Microsoft has a new angle to curb the illegal goods. It has teamed up with Hong Kong record producer Go East to kick off an antipiracy campaign with a rock song.

In a song co-written by Microsoft, Cantonese pop singers Anthony Wong and Lao Lang praise the beauty of a cyber-world free of illegal software. Microsoft says the tune, now heard in Chinese public service announcements, deals indirectly with piracy issues by celebrating the joy of creative freedom. It's too early to know if lyrics such as "It comes from where it comes, no one can withhold it," can



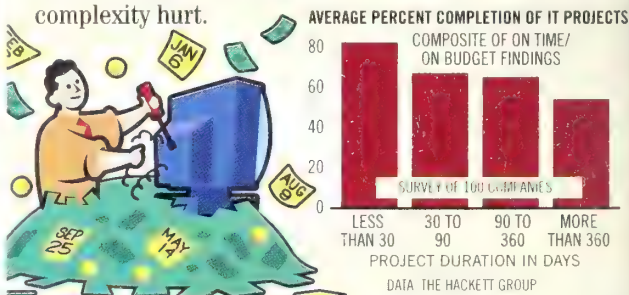
TUNEFUL: *Rocking copycats*

reduce piracy in China, where an estimated 96% of software sales are illegal. Microsoft is also offering freebies to get its message across. Buyers of selected PCs with Windows 95 get a copy of Wong's single *Come Along*, title song of the campaign. The song, along with others, is also available on a separate CD. The first 10,000 people who buy a Microsoft Internet Explorer 4.0 CD-ROM also get the single for free. *Marcia Stepanek*

THE BIG PICTURE

A DAY LATE AND (MANY) A DOLLAR SHORT

Installing new computer systems? The average company completes only 37% of big information technology projects on time, only 42% on budget. Poor management and undue complexity hurt.



FOOTNOTES

Employees using direct deposit for paychecks: Japan, 99%; Germany, 95%; U.S., 46%



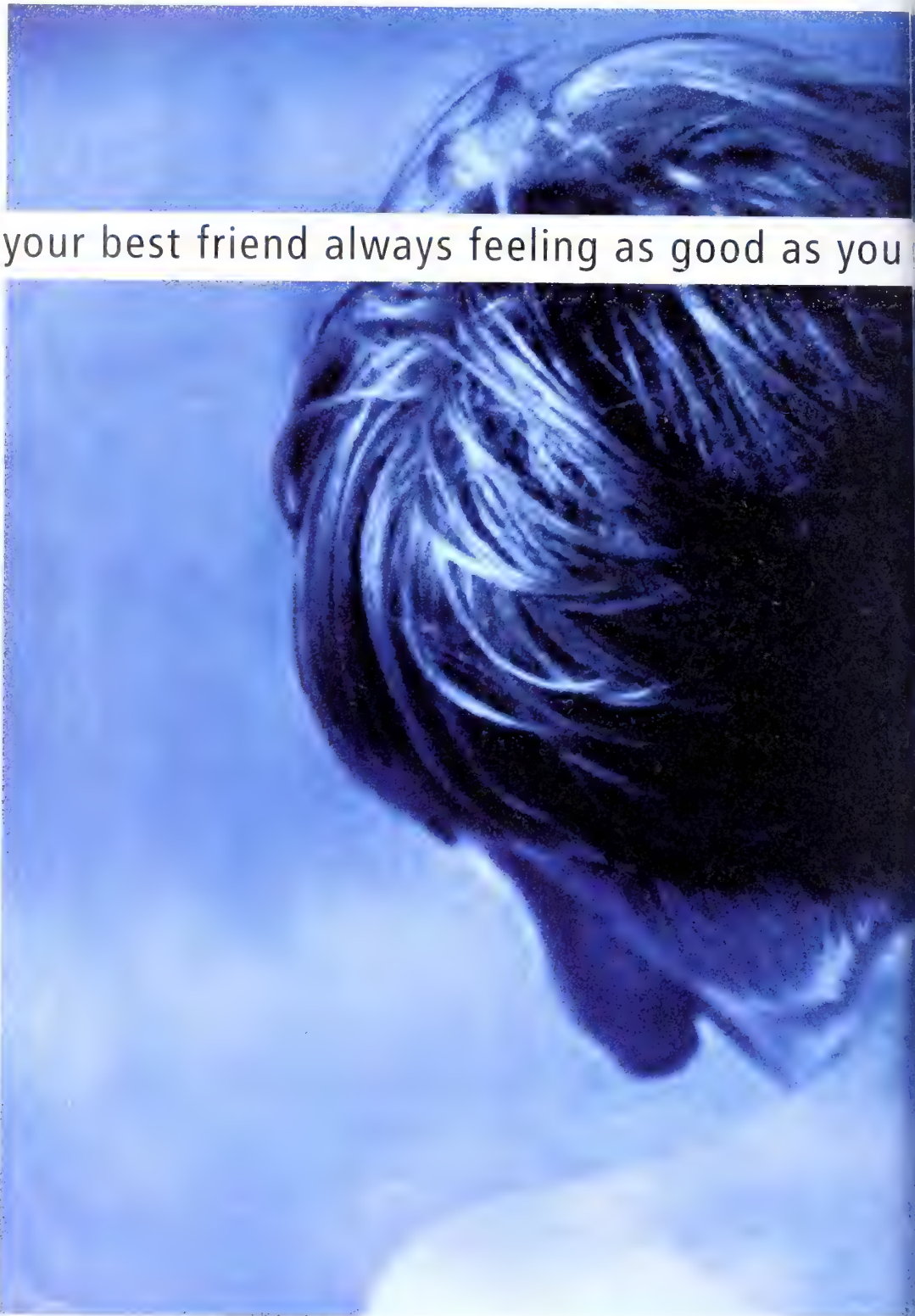
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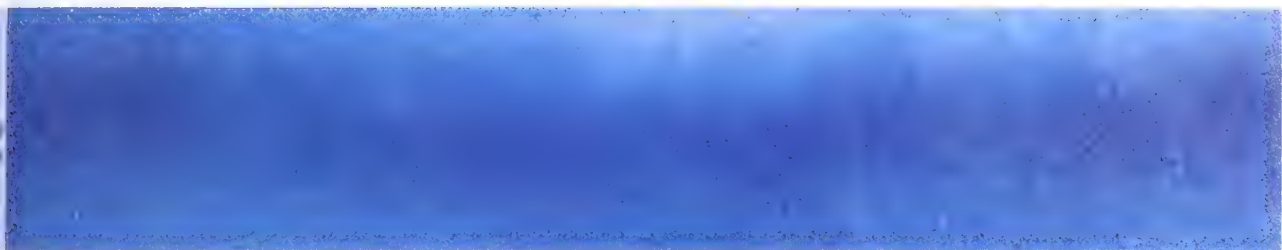
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PR: THE POT CALLS THE KETTLE BLACK

In "The high priest of hype" (Books, Aug. 17), Marilyn Harris unfairly maligned the thousands of people who make an honorable living in corporate public relations. As someone who has practiced corporate public relations for 16 years, I take issue with Ms. Harris' statement that "In PR, truthfulness is rarely even on the radar screen as a value, except perhaps as a convenient option or legal consideration."

As in any profession, there are some PR people who do not maintain high ethical standards. But Harris has chosen to paint all PR people with the same brush, in the same way that some people would smear the journalistic profession by pointing to the unethical practices of tabloid journalists. BUSINESS WEEK should know better than to smear the thousands of hardworking PR people who have assisted them in putting out an accurate magazine every week by helping reporters check facts, arranging interviews with executives, and in some cases even providing interesting story ideas.

Bernard J. Kilkelly

Vice-President
Corporate Communications
Enhance Financial Services
Group Inc.
New York

Marilyn Harris' characterization of the public-relations industry is unfair and inaccurate. While claiming that journalists remain committed to seeking the truth, she contends that "truthfulness is rarely even on the radar screen" in PR. This is a gross distortion. We advise our clients that rule No. 1 of media relations is to tell the truth. Ours is not the only PR agency to have resigned accounts or declined business from companies that want professional liars, not professional communicators.

At best, Harris' analysis is poorly timed, given recent examples of journalists caught writing columns with invented characters or filing false stories. Viewed through the prism of these un-

fortunate experiences, media might want to think twice about throwing stones at PR people from their glass houses.

Robert W. Pickel

Executive Vice-President
Envionics Communications
Stamford, Conn.

INDONESIA NEEDS TO PROTECT ITS CHINESE

Thank you for "The plight of the ethnic Chinese" (International Business, Aug. 3). Your timely and accurate article is the first time I have seen the status of treatment of Chinese Indonesians discussed in print. You have courage to inform the public of how essential and progressive the overseas Chinese have been in Indonesia's economic life. For eight generations, the Chinese have contributed in many ways to the agriculture and industry of Indonesia. My Indonesian-Chinese friends were proud in gaining expertise and applying their skills to modernizing the archipelago. Now, the companies, plants, and businesses they worked hard to build lie in ruins.

One point you did not mention was the emigration of more than 100,000 Indonesian Chinese from Java in 1959-60. Social unrest, the closing of Chinese schools, and loss of confidence in the financial system caused many families and young persons to leave Indonesia. In that period, most of the emigrants departed for southern China. Now, this cycle is repeating itself with vicious overtones. Many of these Indonesian Chinese live in Hong Kong. Since those holding many levels of jobs left, Indonesia's standard of living has suffered. If Indonesia as a whole is to return to prosperity, the country desperately needs the skill, education, and capital that only the Chinese can provide.

James C. Carey
Wilmington, Del.

I am outraged by the remarks made by the newly installed Indonesian President B.J. Habibie. One cannot help but notice the indifferent overtone of his stance on providing basic physical pro-

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on to the Chinese and preventing violence. Habibie is shameless to say that if the Chinese were not to operate," they would see their as-burned to the ground and suffer fate of murder, gang rape, and torture. Words such as these can only be viewed as a blatant declaration of government-sponsored extortion and at against the Chinese, whose only crime is running the country's economy while abiding citizens of Indonesia. Inaction on the part of the Indonesian government to protect the Chinese during the riots only fosters the traditional attitude of discrimination and distrust long accepted by Indonesian society. It also makes evident the unwilling mentality of those in power to use the Chinese as scapegoats for the massive economic failure caused by their reckless monetary policies, flawed policies, and, most of all, rampant corruption. Habibie must take immediate measures to curb further violence, punish the perpetrators, and guarantee basic human rights to the tens of thousands of Chinese ancestry. The world does not need to witness another campaign of ethnic cleansing.

William C. Liu
Hoboken, N.J.

Our article on the anti-Chinese attacks in Indonesia reveals a level of hatred and government-condoned violence that we in the West can hardly imagine. Equally horrifying were attempts by Habibie to portray the attacks as not being anti-Chinese. I think the world, and especially the International Monetary Fund and the U.S., should demand certain minimum standards of decency from the Indonesian government before lending a helping hand.

Tomas Kong
San Mateo, Calif.

LABOR WOES NOT OVER YET

Baron Bernstein makes a good point about "What price peace?" (News: Analysis commentary, Aug. 10). General Motors Corp. lost a lot in the recently

ended strike. It is less clear what those losses were for the United Auto Workers. What about its members who forfeit roughly \$1 billion dollars in wages because of the GM shutdown? Also not counted among the losers by Bernstein are GM shareholders, including the union pension fund, whose future economic gains are compromised by the fact that none of the fundamental issues involving the competitive disadvantages of GM compared to other producers of cars in the U.S. have been resolved.

Perhaps a year of labor peace will allow the parties to agree on a strategy for shrinking GM and its workforce, increasing efficiency, and shoring up GM's shrinking market share. Even if labor relations between GM and the UAW were not so sour, however, that seems unlikely. There are few places in the economy where workers without cutting-edge high-tech skills can earn wages equivalent to the huge "economic rents" enjoyed by GM workers. Thus, displacement from their GM jobs means a fu-

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CORRECTIONS & CLARIFICATIONS

"Sonic Foundry may live up to the hype" (Inside Business, Aug. 17) should have stated that the initial public offering price of Sonic Foundry (SFO) was \$15 a unit, or \$7.50 a share.

"Andrew, what big eyes you have" (In Business This Week, June 1), the date for the launch of the new \$20 bill was misstated. It is set to circulate on Sept. 24.

Readers Report

ture of much lower earnings for these workers. The UAW can be expected to fight to protect those rents, and GM doesn't have time to let attrition take care of the problem—1999 may really see a “cataclysmic battle.”

Ken Deavers
Chief Economist
Employment Policy Foundation
Washington

CLONING'S REAL IMPACT: LONGEVITY

In “Human clones: It's decision time” (News: Analysis & Commentary, Aug. 10), John Carey does not mention what may be the greatest impact of cloning on society: the cloning of organs and other body structures for transplant that are free (or nearly so) from the problem of rejection. This will have a significant impact on improving health and longevity. Anyone who has ever been to a nursing home will realize that increased longevity can be more of a curse than a blessing.

Eugene J. Fenster
Lee's Summit, Mo.

HOW BLIMPIE IS CRUSHING ITSELF

Regarding “Half a loaf at Blimpie” (The Corporation, Aug. 10), if you think something is rotten in Denmark (actually, Hoboken), you should look at the investment from a franchisee's standpoint. As a former franchisee, I can offer that perspective. Investors are not the only ones left with crumbs. By the time Blimpie suppliers make their requisite contribution to the “purveyor fund,” the food and paper costs are so high that there is not enough margin to make a reasonable return.

Anthony P. Conza and David L. Siegal better save their trademark money for toll fare because once the franchises lose enough money, the continuing fees will dry up and all that stock will be really worthless. And then they, too, will be left with crumbs.

David B. Yarborough
Mt. Pleasant, S.C.

CARE FOR YOUR WORKERS OR DON'T SELL HERE

Aaron Bernstein's analysis of unionized manufacturing job losses invests these losses with the same inevitability as water flowing downhill (“Up in arms but down in clout,” News: Analysis & Commentary, Aug. 3). Unlike water, jobs can flow uphill if this nation uses its

most potent weapon. I refer to the desperate need of every major exporting nation for access to the U.S. market, the world's richest. For too long, we've given this access to everyone.

Now it's time to make exporters that profit from coolie wages pay up. A simple market-access tax should be levied against any exporter that pays workers less than their country's equivalent of the average U.S. manufacturing wage. This tax could cause the General Electrics, GMS, and Huffys mentioned to make a 180-degree turn in their plant relocation decisions.

Leigh Johnson
Massillon, Ohio

BIGGER IS BETTER FOR SBC

You were right to point out in “Big mergers, bad service” (News: Analysis & Commentary, Aug. 10) that in contrast to many telecom companies today, service and installation times at Pacific Bell have improved considerably since the company's merger with SBC Communications Inc.

Customer calls are being answered more quickly, thanks to 3,000 new jobs we added, the majority in customer-service positions. In the broadest rollout of new Digital Subscriber Line network technology in any state, we're providing Californians in 200 communities with high-speed Internet access. And we are about to inaugurate our landmark \$50 million Community Technology Fund to expand telecommunications services for traditionally underserved populations. Bigger can be better for consumers, as our merger with Pacific Telesis proves.

Royce Caldwell
President
SBC Operations
San Antonio

WANT TO SEE A REAL SOCIAL SECURITY MESS?

I was disappointed when Laura D'Andrea Tyson suggested in “Tax cuts? Let's not give away the store” (Economic Viewpoint, Aug. 10) that a government-run Social Security trust fund could solve its deficit by diversifying into equities and adjusting the retirement age vs. the “extreme measure” of privatization. These decisions clearly should not be in the hands of the government.

Let's think for a moment of a world in which these suggestions exist: How would AT&T feel about a U.S. government equity investment in Teléfonos de

México American depository receipt? How would the Mexican government react? A government equity investment in Ford... but not GM? “Investment advisers” would really be lobbyists. Furthermore, government ownership of business is socialism.

However, Tyson was correct that retirement age needs some adjustment. In fact, every American must have the flexibility to decide when he or she should retire. As the government projects a surplus, now is the best time for a real privatization of Social Security. I did find it ironic that the article characterized Social Security as the “crown jewel” of federal programs. Precious stones/metals have been one of the worst investments over the past several years.

Tim Page
Bloomfield, N.J.

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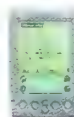
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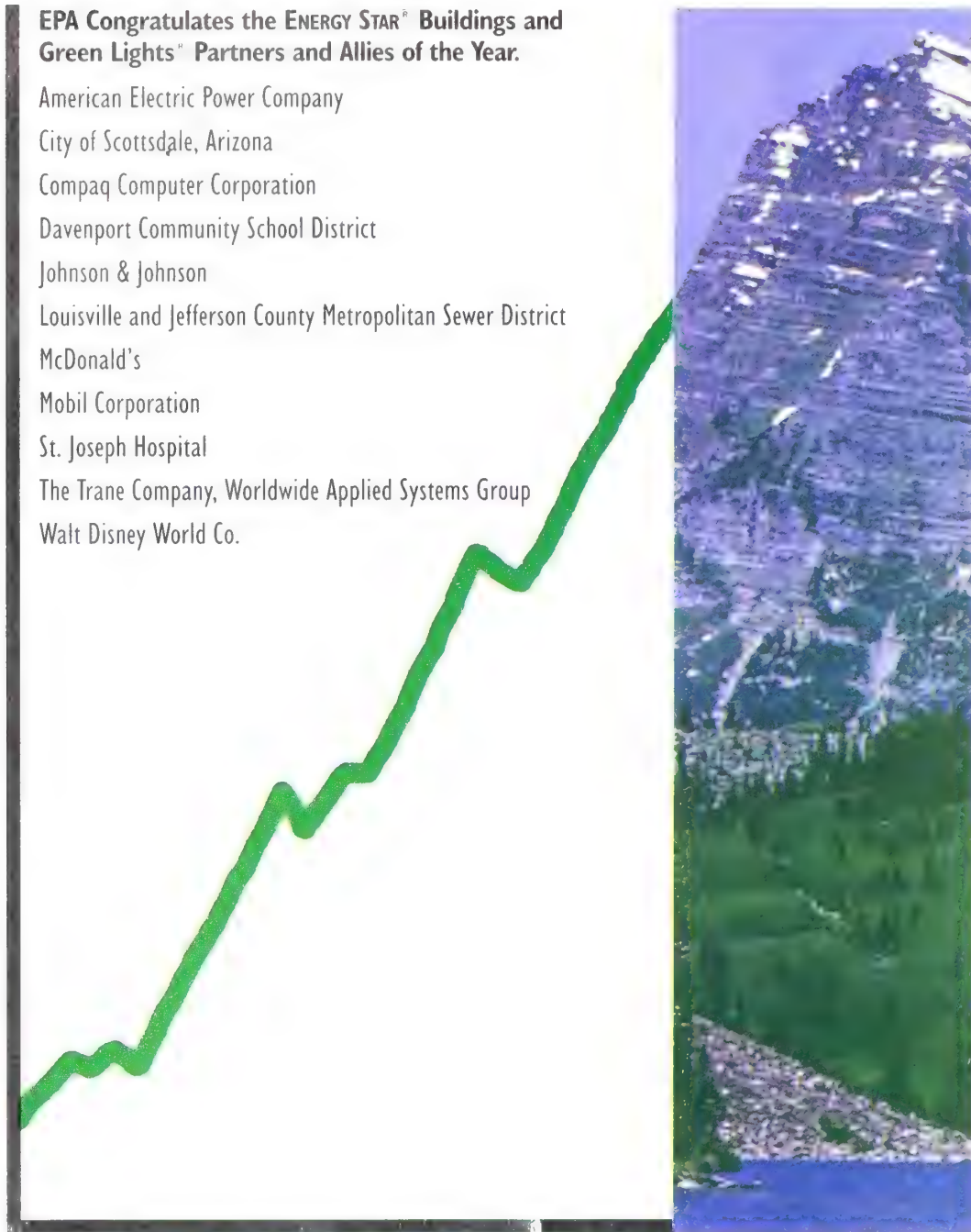
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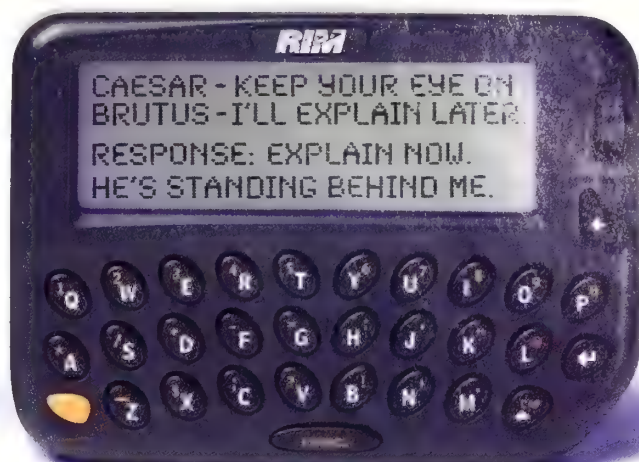


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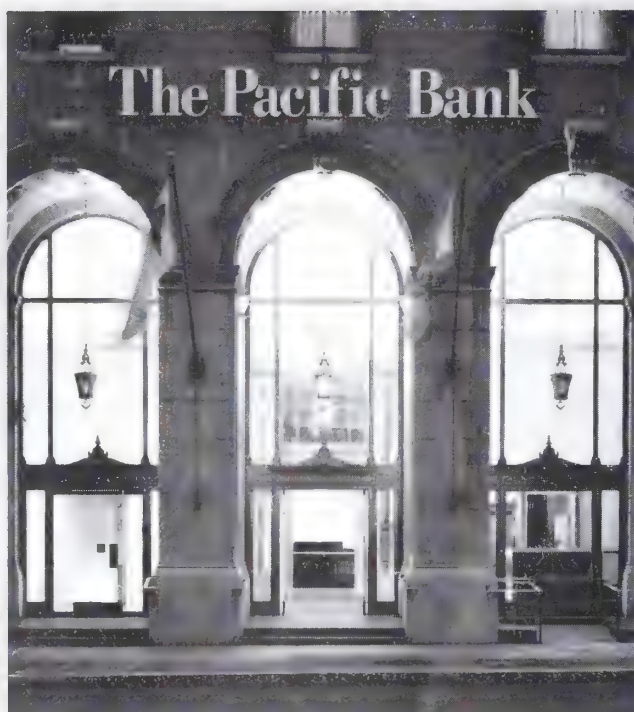
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14 THE MOTLEY FOOL INVESTMENT WORKBOOK by David and Tom Gardner (Fireside • \$12) *"So where do I find stocks?" and other queries, asked and answered.*

15 PERSONAL FINANCE FOR DUMMIES by Eric Tyson (IDG Books • \$19.99) *Lighthearted primer.*

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HOT TYPE

THINKING OF QUITTING YOUR DAY JOB TO trade stocks full-time for your own account? Then you might pick up some tips from *The Electronic Day Trader*, No. 5 on this month's hardcover best-seller list. It doesn't confuse its approach with conventional investing. Day traders execute hundreds of trades a day, hoping to pick up profits on tiny share-price moves. They shirk data on company earnings or analysts' ratings, making decisions on the basis of blips on charts and a steady flow of trading data. If you really have this kind of video-game-like investing in mind, you'll want to learn some of the book's highly technical strategies. A typical bit of wisdom: "Stocks that are down on day and reverse, and turn positive on the day, are fre-

quently good buys when crossing from minus to plus." You may also benefit from the book's history of how changes in regulations and electronic access to information have leveled the playing field between Wall Street and the rest of us. But bear in mind: Day trading is not for everyone. To implement the book's strategies, you must tap into pricey online trading systems with advanced charting and detailed, real-time quotes.

Authors Marc Friedfertig and George West are veteran day traders, but they aren't writers—the book is dense and occasionally impenetrable. Then again, readers of *The Electronic Day Trader* probably aren't after a good read as much as tips on making a fast buck.

BY AMEY STONE

ECOLOGY OF FEAR

Los Angeles and the Imagination of Disaster

By Mike Davis

Metropolitan Books • 484pp • \$25

THE HELLISH PARADISE THAT IS LOS ANGELES

Los Angeles defies easy description. At times, it can be the ugliest place imaginable: Through the yellow-brown haze, one street crossing resembles the next—three gas stations and a strip mall, repeated as far as the eye can see. At other times, especially after a cleansing winter rain, L.A. makes good on all its hyped promise: Zip along its freeways, and behold a glistening jewel fringed with swaying palm trees and snow-capped peaks.

Hell or Paradise? The paradox of Los Angeles goes far beyond its architecture and weather patterns. With its movie stars, sun-tanned surfers, and tawdry scandals, L.A. has always loomed large in the American psyche as a place full of excitement and youthful vigor but also dangerous glamour and moral compromise. Common doomsday wisdom has long maintained that it's just a matter of time until a depleted Los Angeles, with its foul air, packed freeways, and partying celebrities, crumbles into the sea when the Big One hits.

It is the dark side of Los Angeles that fascinates author Mike Davis. In his widely acclaimed 1990 book, *City of Quartz: Excavating the Future of Los Angeles*, Davis probed the deep social and racial divisions that then seemed destined to pull the city apart. Two years later, when riots rocked L.A., Davis' prophecies proved right on target. Now, in his astute new book, *Ecology of Fear: Los Angeles and the Imagination of Disaster*, Davis predicts L.A.'s coming environmental and spiritual collapse.

For Davis, a MacArthur Fellow who has taught urban theory, Los Angeles is already a lost cause, the sad result of a century's worth of civic hubris: greedy speculators and corrupt politicians rushing to destroy the once-bucolic "Land of Sunshine." Onto a semi-arid Mediterranean landscape, "Anglos" have

swarmed from the East, ignorant of their new surroundings and eager to irrigate the parched land, level mountaintops, and erect endless rows of flimsy stucco houses. Now, Davis warns, Angelenos must reap the horrors of years of environmental arrogance.

It's a compelling thesis, made all the more persuasive by Davis' meticulous examination of the intersection of capitalism and the forces of nature. When firestorms engulf whole mountain ranges, taking with them million-dollar Malibu mansions, it's not some freak of nature, as the local TV news reports proclaim. Rather, asserts the author, it's the consequence of a misguided policy to protect those very same houses. Under natural conditions, parched underbrush burns frequently but briefly. Now, the chaparral accumulates for years, sometimes decades, only to ignite into uncontrollable firestorms. Similarly, rains that would have been harmlessly absorbed into the soil become dangerous, raging torrents as they funnel down streets and into the concrete-lined Los Angeles River.

In Davis' Los Angeles, nature bites back in ominous ways. By the mid-1940s, mountain lions were thought to be eradicated from the county. Then, beginning in the 1980s, lions began attacking hikers and picnickers, showing a particular fondness for small children. The lions, it turns out, never vanished. They simply receded into the rugged local mountains only to reappear as urban sprawl swept up the foothills.

The worst folly of all—the misguided belief that the cataclysmic movement of tectonic plates beneath the city can somehow be managed—will exact a far

higher death toll, Davis insists. For 100 years, the plates have been in a quiet period. Citing scientific journals, he argues that the 1994 Northridge earthquake could be the beginning of a new era of destructive temblors. In Los Angeles, despite what the boosters say, remains horrendously ill-prepared for the Big One—and not-so-big ones, too. Even modern skyscrapers, long promoted by architects as the safest place to be in a quake, "are poised to become rubble or towering infernos."

On the subject of environmental management, *Ecology of Fear* is an enormously convincing and terrifying work. Yet it suffers from a conspiratorial and overly polemical tone. L.A. is a big city with big problems. But its shortcomings are as much a result of simple careless planning as of corporate greed. Moreover, in many ways, the place is improving. For one thing, the air is much cleaner than it was 30 years ago, thanks to stiff federal regulations.

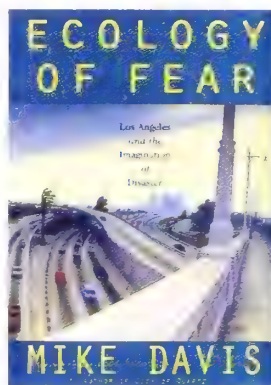
But where the author actually misses the mark is in his economic analysis. Mike Davis, the wealthy liberal, is idyllic gated communities oblivious to environmental dangers, while the poor immigrants outside the gates live in squalor. In Los Angeles has evolved into a dystopian symbol of Dickensian inequalities and intractable racial contradictions." Economic hardship

since the 1992 riots, moreover, has "reinforced spatial apartheid." In truth, over the past three years, racial tensions have been greatly diffused by an economic rebound unmentioned by Davis.

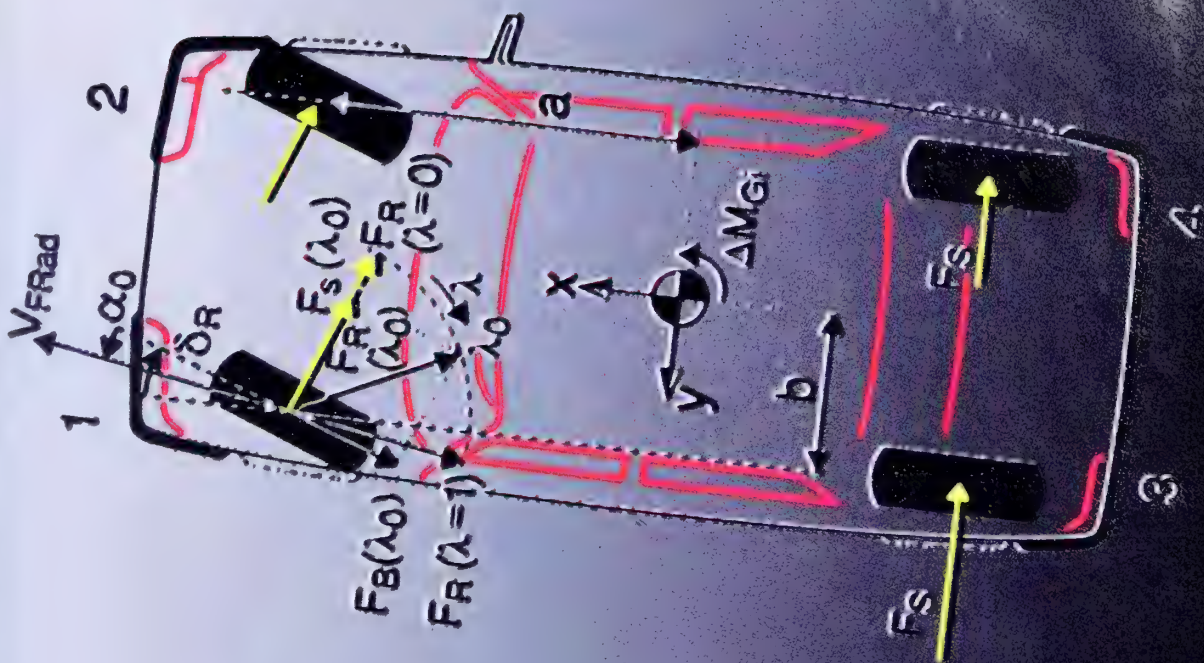
Davis, though, is too busy mapping out the city's downfall to dwell on its current prosperity. In his chapter "The Literary Destruction of Los Angeles" Davis tells how writers and filmmakers have long enjoyed imagining the city's demise. Davis' book belongs squarely in that camp. In the real world, Los Angeles remains a vital if troubled place. It may not be perfect, but Los Angeles is still with us. And that's goodness for that.

BY ERIC SCHIN

Schine worked in BUSINESS WEEK's Los Angeles bureau from 1989 to 1999.



AFTER YEARS OF ENVIRONMENTAL ARROGANCE, DAVIS WARNS, IT'S PAYBACK TIME FOR ANGELENOS



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BOSCH

BY STEPHEN H. WILDSTROM

IS APPLE'S iMAC FOR YOU?

Its simplicity, which makes it ideal for first-time buyers, is also its drawback

In some ways, Apple Computer's new iMac, the most interesting personal computer to hit the market in some years, is a bit of a throwback. Like the original 1984 Macintosh, the \$1,299 iMac, which went on sale Aug. 15, is an all-in-one design with no provision for expansion. And like the original Mac, it marks a clean and exciting break with the past.

The iMac comes at a time when some excitement is welcome. Desktops running Windows on some variant of the Pentium processor keep getting cheaper, faster, and more boringly alike. Even Apple's G3 desktops have failed to rise above the bland.

SNAPPY START. Is this fast new computer with a built-in monitor in a curvy translucent teal-and-white case the right choice for you? First off, going with any Apple product means choosing MacOS over the vastly more popular Windows. About a year ago, when Apple's future was uncertain and software developers were abandoning the Mac in droves, I would have had grave reservations about this. But Apple has survived its near-death experience. Microsoft has shipped the excellent Office 98 for the Mac. And while software options are far more limited than for Windows, they are adequate, especially for home and educational use. (Business software, especially for accounting and database management, is scarcer.)

The main virtue of the iMac is its simplicity. You really can get the machine out of the box and running in about five minutes. You can be connected to the Internet in another five if all goes well, although that's often not the case. Apple couldn't do much about the vagaries of dial-up connections to the Net, and trying to hook up to some Internet services could leave you with a maddening conflict between the iMac software and the service. If you are content to use EarthLink as your service, the preinstalled software on the iMac works just fine. That means first-time buyers, for whom the iMac is ideal, won't have to struggle to get it working with an existing Internet account.

People who don't know much about computers, and don't want to learn, will also find the iMac appealing. It's a shame that the iMac won't really be available in quantity until sometime this fall, because its compact design and built-in networking make it ideal for dorms.

Unfortunately, the very simplicity that makes iMac appealing to some buyers is a drawback for others. If you don't have a lot of data or software on floppy disks and don't need to use them to share information with others, you may never miss the floppy drive that Apple chose

to leave off. But if you need removable storage, you'll have to spend \$150 for an add-on unit—and put up with an external drive and cable that makes a bit of a mess of the iMac's elegance.

Apple's choice of the new universal serial bus (USB) as iMac's only way of attaching accessories allows owners to use the flood of devices designed for Windows 98—provided that the necessary Mac software is available. But current Mac printers will only

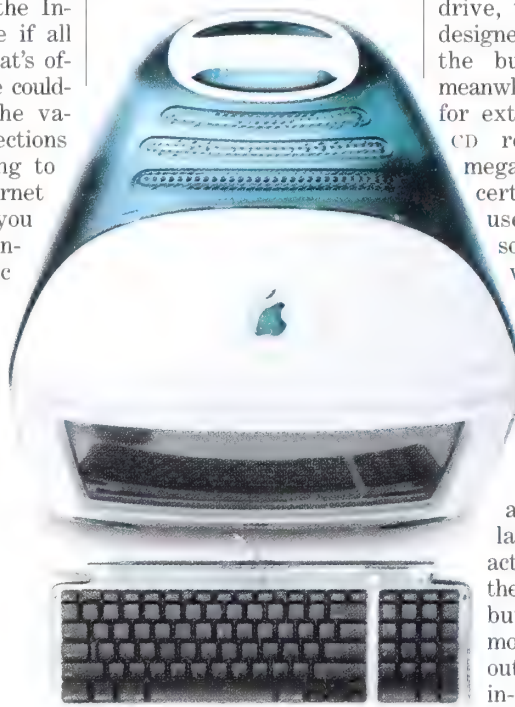
work with the iMac through adapters, and existing external disk drives and scanners that use a regular Mac interface won't work at all.

The biggest drawback of the iMac's design is the lack of expandability. The only thing you can add inside the case is memory. While the iMac could benefit from extra 32 megabytes of RAM, the difficulty of installing it means that this job is best left to a pro. There's no provision for a digital video drive, though one could be designed as a substitute for the built-in CD-ROM. Meanwhile, the iMac's lack of external hard drive

and CD recorders. The 233-megahertz G3 processor is certainly fast enough for use with video editing software, but there's no way to link your iMac to a video recorder to the iMac.

One of the iMac's major attractions has always been its strength in image editing, desktop publishing, and web page design, which are increasingly popular home and student activities. The iMac has the hardware for these, but that dinky 11.5-inch monitor makes page layouts a pain, and the all-in-one design rules out an upgrade.

Depending on what you expect from a computer, these drawbacks may or may not be problems. If you are a longtime Mac user with a lot of accessories and lots of software on floppies, you'll be happier with one of Apple's more expensive but more versatile G3 desktop systems. If you want the cheapest possible computer, go for one of the many sub-\$1,000 Windows machines. But if you want an easy-to-use machine with style and if you're not bothered by the iMac's limitations, this distinctive machine could be a very happy choice.



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BY ROBERT KUTTNER

GLOBALIZATION'S DIRTY LITTLE SECRET



TWO FACES
American
manufacturers
scream bloody
murder over
closed
markets but
happily reap
windfalls from
overcharging
foreigners

The price of gold in London almost equals the price of gold in New York. Otherwise, traders would buy in the cheaper market and sell in the dearer one. This process, known as arbitrage, enforces what economists call the "law of one price"—namely, that in a perfectly free market the same product, net of transaction costs, will sell for the same price everywhere.

Why, then, do Levi's jeans cost double in London what they cost in New York? Why does the same compact disk, fridge, or dishwasher cost the British consumer more in pounds than it costs the U.S. consumer in dollars? Why does a Ford Escort sell for about \$10,000 in the U.S. and \$20,000 in Britain?

OVERPRICED. Only a small part of this difference, it turns out, can be explained by the higher consumption taxes, shipping costs, or duties. Most of it reflects plain old monopoly pricing, which makes British consumers effectively poorer. In this case, Britain has much weaker antitrust laws than the U.S. and a stronger tradition of price maintenance—and American manufacturers are happy to collude. Supposedly, price competition "between" manufacturers solves this problem. But in Britain, everyone's CDs, jeans, autos, etc. are overpriced.

In principle, some clever entrepreneur could buy jeans at the U.S. wholesale price and ship them to a discount emporium in Britain. But if you try to do that, the manufacturer is free to refuse to sell to you. Even if you buy retail in the U.S. for sale in a higher-priced foreign market, you could be infringing on somebody's exclusive distribution arrangements or the manufacturer's copyright or trademark. In Britain, retail chains such as Tesco have been rebuffed by the manufacturers when they tried to discount Calvin Klein and Nike brands. The British Office of Fair Trading sided with the manufacturers.

The globalization of price competition, in short, is lagging far behind the globalization of commerce. Price-rigging remains a form of "nontariff barrier" that nobody is seriously contesting. Neither the rules of the World Trade Organization, the European Union, nor the domestic antitrust laws of leading nations reach this problem.

The European Union, supposedly now a single market, still displays surprising national price differences for identical products.

A report released on July 10 by the European Commission found auto price disparities between Britain and Ireland as high as 40%. The British government colludes with Japanese auto makers (who have been keen enough to build plants in Britain) to impose quotas on imports by independent distributors from Japan, where the domestic auto prices about half the British price.

You might think that in an age of global corporations, mail-order catalogs, and Internet sales, global consumer prices would have long since converged. But no. In some respects pricing disparities and barriers are becoming more entrenched. A recent case decided by the European Court upheld the right of an Austrian eyeglass maker to sell its products more cheaply outside the EU and to sue anyone who tried to reimport the discounted glasses for resale in an EU member country. Men's madras shirt from Lands' End cost \$29.50 in the U.S. catalog and £28.50 (\$46) the British one. Only about a third of the premium is value-added tax.

CHANCE FOR BLAIR. The term for all of this is "pricing to market." Despite globalization, it remains rampant. And while some national antitrust laws effectively restrain price maintenance within nations, they hardly touch globally. When price maintenance by foreign distribution systems has the effect of keeping out U.S. products (as in Japan), American manufacturers and the U.S. Trade Representative scream bloody murder. But what the effect is to let in U.S. products but retard price competition (as in Britain), the American manufacturer happily—and quietly—reaps windfall at the expense of foreign consumers.

It is intriguing that Britain should be hotbed of price-rigging. Since 1979, British Thatcherism has preached the bracing virtue of swashbuckling free markets. But Thatcher-style capitalism was more for capitalists than consumers. If the Labour government of Tony Blair got serious about antitrust, Blair could dramatically raise British living standards overnight.

As long as price discrimination benefits producers, markets are less than self-correcting—and antitrust regulation has a necessary role. Today's newly globalized market needs regulations promoting competition. The WTO has lately begun sniffing around this issue as a new species of trade barrier. It should persist.

Robert Kuttner is co-editor of *The American Prospect* and author of *The End of Laissez-Faire*.

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BY GENE KORETZ

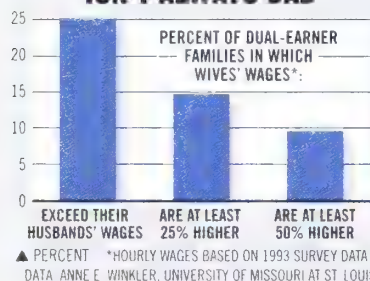
WIVES WITH FAT PAYCHECKS

Many now outearn their husbands

Although the picture of the typical American married couple as breadwinner husband and stay-at-home wife has long since faded into history, men are still regarded as the primary earners in households. Indeed, survey data reveal that even in marriages where both partners work full-time, women on average still earn only about 70% as much as their spouses.

Averages, however, can be deceiving. What may have escaped notice, observes economist Anne E. Winkler of the University of Missouri at St. Louis

THE BIG BREADWINNER ISN'T ALWAYS DAD



in a recent study, is that the gap between male and female earnings in many marriages is relatively small. In a growing number of cases, in fact, wives now bring home more of the bacon than their husbands.

It's hardly news, of course, that most married women work. Since 1966, the percentage of wives in the labor force has risen from 35% to 62%—and 75% if only those under 65 are counted. Census data indicate that dual-income couples last year hit 30.5 million, far outpacing the 11.4 million marriages in which only the husband worked.

Meanwhile, the gap between male and female wages has been shrinking—because of falling real earnings among poorly educated men and generally rising earnings among women. Indeed, adjusting for the difference in women's education, experience, and occupations, economists Francine Blau and Lawrence M. Kahn of Cornell University have estimated that hourly wages of female full-time workers came to 88% of male wages by the end of the 1980s.

A measure of the degree to which such trends may be affecting gender roles within marriage, says Winkler, is the rising share of dual-income couples in which wives earn more than their husbands. Back in 1981, that fraction was just 16%. But by early 1993, she reports, it had risen to 25.2%. Moreover, close to 10% of wives in this group were earning at least 50% more in hourly wages than their spouses (chart), and 20% had greater annual earnings.

Winkler's analysis of working couples indicates that close to 60% of men with low pay (in the lowest fifth of the male earnings distribution) had wives whose pay exceeded their own, compared with only 7% of men in the top fifth of earnings. Further, 2.8 million women were the sole wage earners in instances where only one spouse worked.

Looking at total incomes in dual-earner families, Winkler estimates that wives accounted for the lion's share of earnings in 16% of families in the top fifth of the income scale. In fact, there were almost as many high-earning wives paired with low-earning husbands as high-earning husbands with low-earning wives.

DRAWBACKS OF BUYBACK PLANS

The follow-through can be spotty

While corporate announcements of stock-buyback plans are music to investors' ears, many observers have urged investors to take them with a grain of salt. And for good reason. According to a study presented at the annual meeting of the Academy of Management in San Diego in mid-August, few buyback plans are fully implemented.

In the study, James D. Westphal of the University of Texas and Edward J. Zajac of Northwestern University, looked at buyback plans unveiled by more than 400 major companies from 1981 to 1990 and actual repurchases over the subsequent five-year periods (through 1995). In the first half of the decade, the companies announced 148 buybacks and failed to purchase any share only 22% of the time. Moreover, 54% of the announcements were followed by purchases of at least half the shares promised within five years.

By contrast, while the same companies announced 544 repurchase plans from 1986 to 1990, in nearly 40% of the cases they failed to buy back any share over the following five years. And only a third of the plans resulted in buybacks

of at least half the shares announced.

Noting that buybacks often are championed by boards of directors, which include institutional investors, Westphal and Zajac find that the relative power of chief executives and boards—as measured by such factors as CEO and board tenure and board stock ownership—have a big effect on whether buybacks are implemented. The greater the CEO power over a board, they write, the greater the likelihood that a buyback won't be carried out.

Once a buyback announcement triggers a stock rise, the authors theorize, managers become more interested in preserving their control over free cash flow than in distributing it to investors.

STOCK OPTIONS FOR THE RANKS

More companies adopt the idea

The stock market may be looking shakier these days, but the share of Americans with stakes in the market continues to grow. A survey by consultants William M. Mercer Inc. highlights one element in the trend: the increasing number of major corporations that award stock options to most of the employees—rather than just to executives.

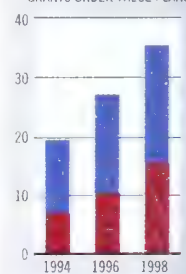
According to Mercer, more than a third of large companies now have broad-based stock-option arrangements covering all or a majority of their employees—more than double the percentage as recently as 1993. Moreover, almost half of this group indicate that they are actually implementing broad-based grants this year—three times as many as did so five years ago.

Advocates say that options for the rank and file can ease tensions over high executive compensation and give workers a stake in a company's long-term growth. Mercer notes that they may be especially useful in today's tight labor markets, helping to recruit and retain skilled workers. A big question, however, is the effect on employee morale if the market tanks.

A BULL MARKET IN OPTION PLANS

PERCENT OF MAJOR U.S. COMPANIES*

■ WITH STOCK-OPTION PLANS FOR A MAJORITY OF EMPLOYEES
■ ACTUALLY MAKING OPTION GRANTS UNDER THESE PLANS



JAMES C. COOPER & KATHLEEN MADIGAN

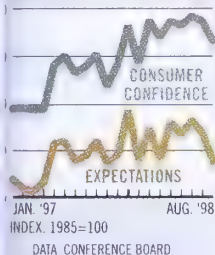
THANKS TO CONSUMERS, THE ECONOMY MAY JUST KEEP ON HUMMING

their spending isn't likely to slow as long as the job market stays firm

U.S. ECONOMY

When the going gets tough, will the tough keep shopping? That question is a crucial one for the economy in the second half. Recent news has roiled the financial markets. The Clinton debacle, Russia, embassy bombings, and military retaliation have made the world look a little riskier nowadays. Will consumers respond to uncertainty by spending less and saving more? A decline—or sharply smaller gains—in consumer spending could be a problem for economic growth, particularly in the fourth quarter. For now, consumers are starting to express some worry about the economy's future. But the latest data don't show them cutting back on spending by much.

SPIRITS SAG ON FEARS ABOUT THE FUTURE



ims suggests a strong gain in August payrolls. And using, the Viagra sector of this economy, just keeps ing (page 38).

At the same time, the Asian financial crisis remains a drag on growth. Real exports are falling, hit by weak demand along the Pacific Rim and the strong dollar. A trade deficit likely is subtracting from gross domestic product growth this quarter, and may well curb growth again in the fourth. That's why real GDP in the second half probably isn't growing as quickly as it did in the first, when the annualized growth rate was 3.5%.

HOW FAR BEHIND will depend on consumers whose purchases account for two-thirds of real GDP. That's why trends in consumer fundamentals bear watching. Household confidence, for instance, has fallen for 10 months in a row, although it remains historically high. The Conference Board's consumer confidence index dropped to 133.1 in August, from 137.2 in July. The index covering the economy's current condition dipped slightly, but the reading on the future fell sharply, from 113.4 to 107.5 (chart). The Board said, "turmoil in

the financial markets, both in the U.S. and abroad," was partly responsible for the downturn.

The Board also noted that consumers seem to be less sure about the job market in August as well as in coming months. However, that worry may prove to be unfounded. The strikers at GM were back at work in August, so the month's payrolls are likely to post a large increase when the employment report is released on Sept. 4. And looking ahead, demand for labor appears quite robust. A survey by the temporary help agency Manpower Inc. shows that hiring plans for the fourth quarter are the strongest since 1977.

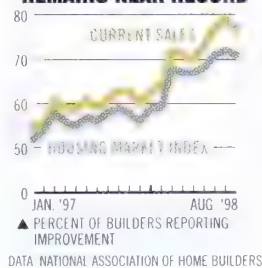
Rosy job prospects will help consumers overcome any Wall Street jitters and keep spending. Retail sales were not strong in July, but the 0.4% drop was an upshot of vehicle shortages caused by the GM strike and the end of dealer incentives. Purchases of motor vehicles plunged 3% in July. Outside of autos, sales rose a solid 0.5%. And after adjusting for inflation, nonauto retail volume began this quarter at a hefty 3.9% annual rate above its second-quarter average.

In addition, consumers continue to buy homes at a record pace. Existing home sales rose 4% in July, to a record annual rate of 4.93 million. New-home sales have also been in record territory, and the demand has kept builders busy. Housing starts increased 5.7% in July, to an annual rate of 1.72 million, an 11-year peak.

Moreover, the National Association of Home Builders says that its members were very optimistic in August. The trade group's Housing Market Index—a compilation of current and expected sales and buyer traffic—fell to just 71% from a record 72% in July (chart). With the flight-to-quality rally in the bond market pulling down mortgage rates, housing should remain vibrant in the second half.

IN COMING MONTHS, consumers will also be expected to help manufacturers overcome the drag from exports and, to a lesser extent, capital spending. Industrial production declined 0.6% in July, but again, that mostly reflected the GM strike. Excluding motor vehicles, factory output was up 0.1% in July, and the early

BUILDING ACTIVITY REMAINS NEAR RECORD



readings for August production show a good rebound.

Even so, industrial activity has slowed significantly this year. That's mainly because Asia's problems are hurting exports and also widening the trade deficit. In June, exports were down for the third consecutive month, dropping 0.5%. For once, though, imports declined at a greater rate, 2%, so the trade deficit that month actually narrowed for the first time since January. The gap slipped to \$14.1 billion, from \$15.5 billion in May.

The narrowing is not the start of a trade turnaround, however. Not only is Asia cutting into foreign sales, but so is the continued rise in the dollar, which makes U.S. goods more expensive globally. One troubling trend is the severe drop in price-adjusted exports. Real merchandise exports in June fell below their year-ago level for the first time in five years. In the meantime, real goods imports were up 10%—a result of the second quarter's robust spending in the U.S.

SLACK FOREIGN DEMAND also shows up in orders taken by durable-goods manufacturers. New orders jumped 2.4% in July, buoyed by a 12% surge in bookings for electronic equipment. But the level of July orders was well below the peak hit in November, and the trend in demand is heading south (chart). The Commerce Dept. does not divide the data between foreign and domestic orders, but other numbers, such as from the National Association of Purchasing Management,

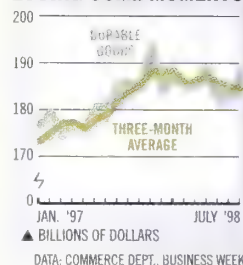
show the softness has come from foreign demand.

In the future, however, some of the weakness may be due to U.S. businesses scaling back their capital spending, another powerhouse for the economy in recent years. Capital spending is very unlikely to decline in coming quarters, but its growth rate will slow. Already, a banking survey by the Federal Reserve shows that loans to large corporations were down in the second quarter. One explanation given was decreased spending on plant and equipment.

Businesses have many reasons to rethink their capital budgets: Weaker foreign demand is erasing the need to add capacity. Slower profit growth is cutting internally generated funds, while falling equity prices have removed a cheap source of financing.

A slowdown in business spending, however, will bring the economy's fortunes back to depending on consumers. For now, individual investors are watching Wall Street with a wary eye. But those concerns are only a small component of consumer fundamentals. A much bigger factor is the labor markets. And as long as job growth does not falter, the consumer outlook is not in jeopardy.

NEW ORDERS ARE LOSING SOME MOMENTUM



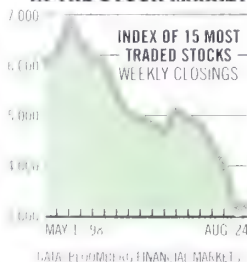
VENEZUELA

A COSTLY CREDIBILITY GAP

Venezuela's tardy, halfhearted embrace of market economic reforms is costing it dearly. As Asian and Russian woes have made markets jittery worldwide, no Latin American country has been hit harder than Venezuela, the region's fifth-largest economy.

First, the Caracas stock exchange has plunged 19% since Aug. 19 (chart) and is down 60% since its peak in March. Second, most analysts believe Venezuela has little choice but to devalue. The government insists that it will keep the troubled bolivar within a trading band, as it has for the past 28 months. But foreign reserves already have shrunk by one-third since November, to about \$14 billion.

VENEZUELA: A BEAR IN THE STOCK MARKET



President Rafael Caldera is trying to avoid a devaluation, at least until after the Dec. 8 Presidential elections. To prevent a meltdown that could drag down neighboring Brazil, Caldera has asked Congress for fast-track authority to implement measures to finance the fiscal deficit, which totals about 4.5% of gross domestic product. Caldera plans to issue \$1.4 billion in domestic bonds, raise some taxes, and create a macro-stabilization

fund to offset plunging oil prices.

That, however, may not be enough to save the bolivar. Although Venezuela runs a current-account surplus and has a reasonable debt burden, inflation is

surging 38% annually and real GDP growth is expected to slow to 1.8% this year, from 5% in 1997. And investors simply don't trust the government to implement significant reforms. While Brazil's fiscal situation is also weak, its authorities have a more credible history of responding to external shocks than Venezuela does. The last time Venezuela faced a big credit crunch, in mid-1994, it imposed exchange controls.

Another concern is the December election. Front-runner Hugo Chávez, who led an abortive coup d'état in 1992, has troubled investors by hinting of a debt moratorium and a reversal of some market-opening reforms. He is also viewed as a populist who might not impose the market discipline that Venezuela sorely needs now.

By Geri Smith in Mexico City



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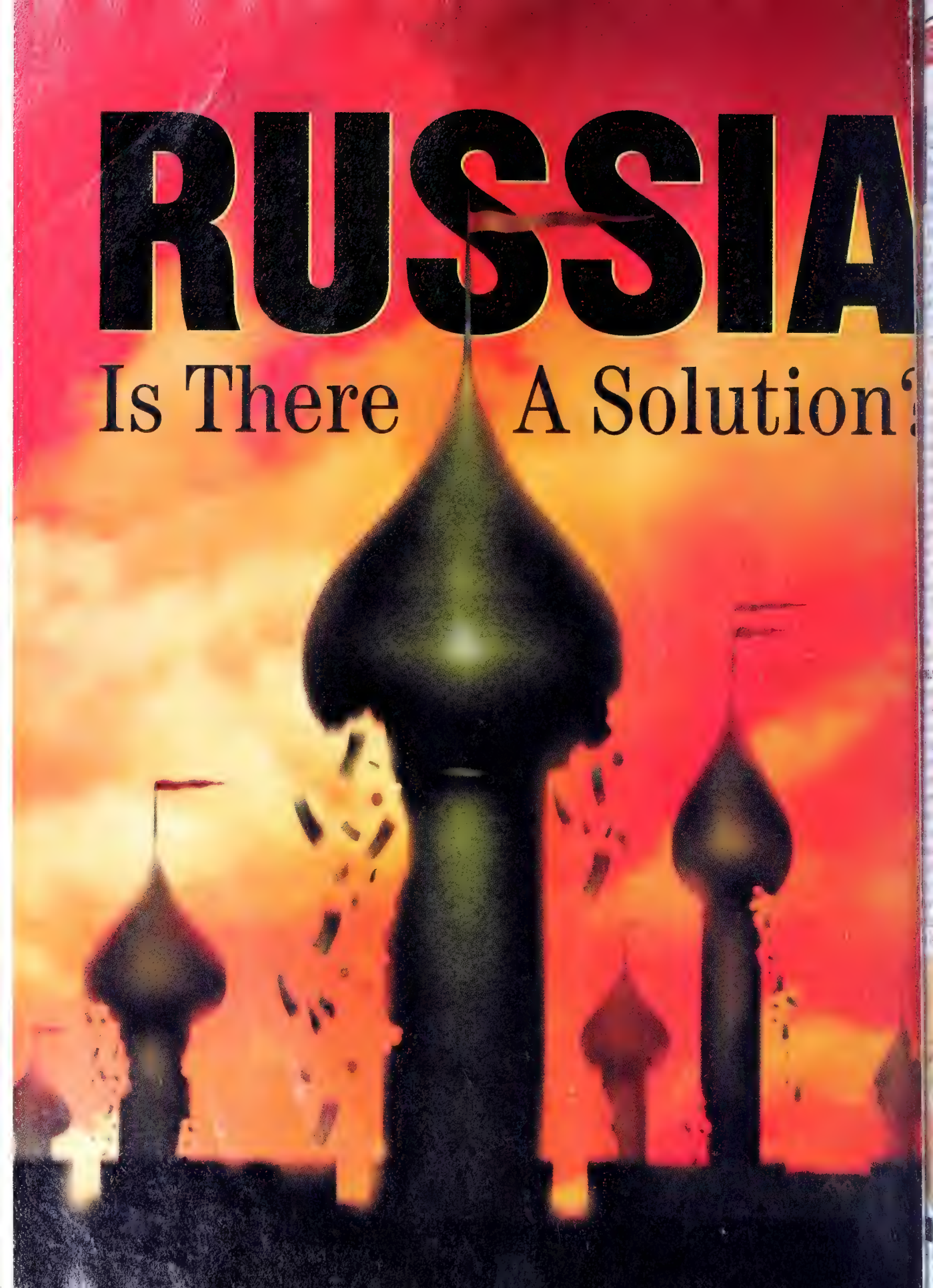
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RUSSIA

Is There A Solution?



It is a bitter August for Boris N. Yeltsin. Nearly seven years to the day after he defeated a coup plotted by hard-liners and helped bring down the Soviet empire, the Russian President experienced his own embarrassing defeat. The triumph of his presidency—a stable ruble—collapsed on Aug. 17 as his government defaulted \$40 billion in short-term debts and devalued the currency. Six days later, Yeltsin humbled himself by reappointing Viktor S. Chernomyrdin, the stodgy bureaucrat he had fired five months earlier, as his Prime Minister. It was, noted *Izvestia*, “like swapping paratroopers in free fall.”

It's far more than that. Russia's economy is melting down amid signs that Chernomyrdin's return to power marks the end of the era of reform. The ruble is collapsing. The financial markets have stopped functioning. Banks are short of cash, stirring panic among ordinary citizens. Within months, Russians could once again be coping with hyperinflation and food shortages. And Yeltsin, already a lame duck, could be forced to resign, prompting elections. Now, in what we are describing as “a quiet panic,” Chernomyrdin is preparing to team up with Communist and nationalist factions in the Russian parliament and with powerful business tycoons to return Russia to a far more statist style of economic management.

IMPLICIT MORATORIUM. Behind the scenes, Chernomyrdin is believed to be pushing Yeltsin to give him power to rule Russia's battered economy by decree. Among other things, insiders say, Chernomyrdin may introduce limits on outflows of capital as well as price controls. The bailouts of some banks may amount to their nationalization. The government's default and its debt moratorium are an open acknowledgment that Russia's top priority is its own internal stability rather than meeting its financial commitments to the outside world.

After years of stagnation, Chernomyrdin wants to reinvigorate the Russian economy, revive industry, and spur economic growth. “Our first priority will be defending the social welfare of the population, paying salaries and pensions,” he declared after his appointment. “By purely monetarist

measures, we will not pull Russia out of the crisis.”

Although the details are sketchy, the power shift in Russia was sparked by banks worried about meeting payments due on syndicated loans from Western financial institutions. Among others, Chernomyrdin ally Mikhail Khodorkovsky's Menatep Bank was under pressure. Indeed, the government caved in and announced its moratorium on the day that he was due to make a payment on an \$80 million loan. But the moratorium and devaluation touched off a wave of panic among ordinary Russians and foreign investors. To preserve stability and their own empires, influential tycoons such as oil and media baron Boris Berezovsky began urging Yeltsin to bring back Chernomyrdin as Prime Minister. Yeltsin also anointed him as his preferred successor.

Chernomyrdin's return is a watershed event. Russia may become the first major emerging-market economy in the post-cold-war era to insulate itself from the forces of globalization. By vowing to pour money into Russian industry, Chernomyrdin seems ready to reject the International Monetary Fund's canon of tight money and belt-tightening. Russia's new stance may tempt countries from Indonesia to South Korea to fend off the market forces that have similarly disrupted their own hard-hit economies.

CLINTON'S CHALLENGE. Russia's free-market failure is a big blow to the West. Led by the U.S., Western industrial nations have gone to great

lengths to hasten Russia's transition to capitalism—from sending economic advisers to lending tens of billions of dollars. With 11,000 nuclear weapons, Russia would become a major threat to global security if it plunged into chaos. President Clinton is now faced with a devilishly complicated task as he heads to Russia for a summit with Yeltsin scheduled for Sept. 1. With the IMF strapped for cash, he can't offer any financial help. As Russia closes ranks against Western market solutions, Clinton will find it much less willing to bow to U.S. interests (page 32).

Meanwhile, global financial markets are also jittery. Investors around the globe had assumed that Russia was too big and politically important to fail. But Russia's debt moratorium

By abandoning reform, Chernomyrdin is inviting hyperinflation, capital flight, and food shortages

RUSSIA'S ROAD TO FINANCIAL RUIN

FEB., 1998 Oil prices fall below \$15 a barrel for the first time in four years

MARCH Yeltsin fires Prime Minister Viktor Chernomyrdin, moving banker Sergei Kiriyenko, 35, to the post

MAY Central Bank dips into dwindling reserves

to defend the ruble as investors flee

JULY To keep Russia from defaulting, the IMF pledges \$22.6 billion in loans over two years in exchange for tough reforms

AUG. 17 Reversing course, government effectively devalues

ruble by 34% and announces a 90-day moratorium on short-term debt payments

AUG. 23 Yeltsin fires Kiriyenko government and reappoints Chernomyrdin

AUG. 26 Central Bank admits it can no longer afford to defend ruble



YELTSIN



CHERNOMYRDIN



Chernomyrdin's go

Chernomyrdin's strategy is straight out of the old Soviet book. The former chairman of gas monopoly Gazprom believes that the backbone of the Russian economy is its industrial enterprises. Since Yeltsin launched his economic reforms in 1992, industrial enterprises have been starved for investment as governments slashed subsidies. At the same time, though, the government kept enterprises afloat by allowing them to pay for electricity, fuel, and other necessities through long chains of wasteful barter deals. This system has become known as Russia's "virtual economy" because it managed to keep millions of workers employed in unproductive factories.

PRESIDENTIAL AMBITIONS. Now, to please his nationalist and Communist supporters in the Duma, Chernomyrdin wants to turn these companies around by flooding them with cash. With no money coming in from foreign investors or international institutions, the only way the Prime Minister can do that is by printing rubles. Chernomyrdin is expected to allow favored private banks run by his powerful business supporters to channel credits to industry. That could further strengthen the grip of powerful financial industrial groups on the economy.

Above all, Chernomyrdin's goal is to become Russia's President. Elections are scheduled for 2000 but could be held much sooner if Yeltsin resigns. Until recently, Chernomyrdin was in the political wilderness. But if he can somehow pull off his rescue plan for Russia, he will stand a chance to upstage more charismatic politicians who have already signaled their intention to run for President: former General Alexander Lebed and the popular Moscow Mayor Yuri Luzhkov.

But Chernomyrdin's hopes could soon fade. The risk is that cranking up the printing presses will lead to hyperinflation and a totally worthless ruble. Increasingly desperate Russians could begin to hoard goods rather than hold on to money. At the same time, the country's financial squeeze and shortage of hard currency may make it difficult to keep up the imports of food and other goods that have flooded shelves over the last seven years. That could pose political and social problems, especially in cities such as Moscow which imports close to 80% of its food.

If inflation takes off, one safety valve for the economy may be the American dollar. Already, millions of Russians hold their savings in dollars stashed under their mattresses, while many companies have bank accounts in the West. As

RED FLAG

Communists and nationalists demand Yeltsin's ouster. A day later, he sacked his Cabinet

torium and the \$32 billion debt restructuring program it announced on Aug. 25 changed that psychology overnight. Investors reacted angrily to the plan, which forces them to swap high-interest, short-term Treasury bills for longer-term ruble bonds paying 25% to 30%. Analysts estimate that investors will receive just 15¢ to 30¢ for every dollar invested. Says E. Gerald Corrigan, managing director of Goldman, Sachs & Co. and a former president of the Federal Reserve Bank of New York: "There was no alternative. But it is a very bad precedent that runs into a head-on collision with the whole global credit system." Adds Robert Devane, a Moscow-based investment adviser: "The restructuring deal will hurt Russia's ability to finance itself in global markets in the West for some years to come."

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BusinessWeek **ONLINE**

...ve all, is to be Russia's President by 2000—or sooner

ussia's ruble crashes, more and more business will likely be done in dollars, either openly or on the black market. That was true in the early 1990s when the dollar circulated parallel to the ruble and kept part of the economy ticking along. In recent weeks, business in dollars has already been picking up as the inevitability of devaluation became clear.

Now, the Russian economy is reeling from an over-collapse in confidence. From St. Petersburg to Vladivostok, the outlook for many Russian businesses—as well as ordinary people—is growing bleaker by the day. Virtually all of the country's 1,600 banks are in trouble. Hundreds of smaller banks are likely to fail in the next few weeks. Even the country's leading banks are feeling the pinch. In the week following the ruble devaluation, seven of Russia's top banks were involved in mergers. The spate of deals was sparked by an offer by the Central Bank chairman of a "velvet nationalization"—bailout loans in exchange for equity stakes in the various banks. Default would convert membership to the government.

PPED IN THE BUD? In Russia's return to statist capitalism, a vibrant part of its economy could be damaged. Alongside a shrunken industry has grown a dynamic private sector encompassing everything from retail stores to computer software companies to small consumer-goods manufacturers. Now, they are caught in the financial squeeze, unable to withdraw their funds from banks or to pay for imported goods. In Moscow and other big cities, middle-class workers

in new private companies are facing a tough autumn. Already, some brokerages and banks are cutting their staffs sharply. If layoffs soar, some observers think the young new middle class could take to the streets to protest Chernomyrdin's regime.

Will Chernomyrdin's counterrevolution succeed? By restructuring Russia's debt, the Russian government has bought some time. Even if Chernomyrdin can delay payments coming due in the future, he will still have to cope with the staggering flaws in Russia's economic system. He needs to attempt to make Russia's enterprises more productive, a task that will undoubtedly involve political pain. And the oligarchic rule of Russia's economy, while providing short-term stability, will continue the corruption and misuse of assets that has plagued the transition so far. Until the oligarchy is broken, Russia's economy won't be able to grow.

Perhaps it was wishful thinking to believe that a country so badly damaged by communism for 70 years could make the transition to capitalism in just a decade. Despite the fervent hopes of Westerners and Russian reformers, Russia moved only partly down the path to a democratic market economy. In the name of guaranteeing prosperity and well-being for ordinary people, Chernomyrdin has returned to power with the strong backing of a small political and economic elite. Now it's up to the Russian people to react—either through the ballot box or in the streets.

By Patricia Kranz in Moscow, with bureau reports



CREDIT SUISSE: THE PERILS OF PIONEERING

In the race to Russia, no one was faster than Credit Suisse First Boston. Arriving in 1991, CSFB almost single-handedly created the Russian equities market. And when the government began selling Treasury bills in 1995, CSFB became the biggest player.

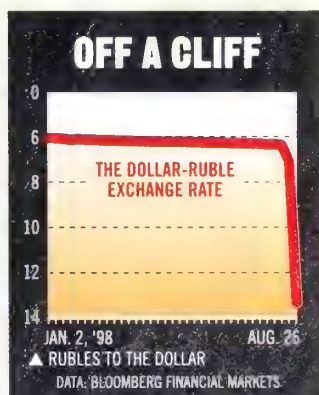
Suddenly, being a pioneer isn't looking so smart. On Aug. 26, CSFB said troubles there and in other emerging markets will slash at least \$254 million from 1998 earnings, but did not disclose the actual numbers.

NO HEDGE. CSFB has company: The same day, Stanley Druckenmiller, manager of George Soros' flagship Quantum Fund, said Soros' funds lost about \$2 billion in Russia over the last year. Investors fear losses may soar if the ruble falls further. Shares of Credit Suisse Group, CSFB's parent, are 25% off their '98 high on Russia worries. Shares of big German banks have fallen as much as 25%.

The unraveling of Russia's econo-

my caught many investors in an unexpected snare. In the past, T-bill investors could hedge their currency bets using forward contracts with Russian banks. But the government has put a moratorium on banks' having to repay forwards—and CSFB estimates its debt restructuring will leave investors with only 15% to 30% of their T-bills' face value. Michael Eggleton, head of CSFB's fixed-income operation in Russia, says many would-be short-term investors have been handed "a six- or seven-year ruble asset, in a time when there's no ability to hedge that risk."

True, if CSFB wrote down all its Russia losses to date, first-half earnings would be only 20% less than in 1997. "We've had a blockbuster year,



if you take Russia out," says Chief Executive Allen D. Wheat. Similarly, Salomon Smith Barney figures the top four German banks' total net exposure is only \$2 billion. Chase Manhattan Corp. says its exposure is about \$500 million, and BankAmerica puts its own at \$412 million.

Still, rumors persist that more big hits are in the offing. Rating agency Fitch IBCA says Russia's moratorium affects only about \$250 million in syndicated loans, but about \$2.4 billion in repo contracts and \$40 billion to \$50 billion of forward contracts. The bottom line: Investors' Russia worries are far from over.

By Carol Matlack in Moscow and Thane Peterson in Frankfurt, with Leah Nathans Spiro in New York

COMMENTARY

By Joan Warner

NO MORE CRUTCHES, NO MORE BAND-AIDS

First Asia. Then Russia. Maybe Latin America next. The world's financial crises are casting long shadows, not just over emerging markets but over New York and Frankfurt as well. Some economists and investors are so scared they are proposing controls on currency or capital flows to stop the bleeding—a giant leap backward from the democratic, free-market policies that were supposed to have won the cold war.

But the markets now in meltdown are free in name only. Russian capitalism created a shell economy in which a few bankers, politicians, and businessmen plundered the country's assets to line their own pockets. Southeast Asia's crony capitalism allowed countries to inflate financial assets with flimsy loans made between friends. Korea still coddles its banks and conglomerates—as does Japan, now in its eighth year of economic stagnation. Even Hong Kong is artificially propping up its stock market to the tune of \$3 billion.

Such systems destroy value instead of building it. They keep profitless enterprises alive with debts that never get repaid. And the hot money from the West that goes along for the ride, expecting to be saved if markets turn sour, just fuels the flames.

When currencies plummet and capital runs for cover, it's tempting to consider extreme measures. Restricting money flows or pegging exchange rates could temporarily contain volatility. But the last thing such countries need is more restrictions on the free flow of money. Instead, they should plunge ahead with reform and let the markets work their discipline.

"MORAL HAZARD." That doesn't necessarily mean doing the International Monetary Fund's bidding in return for bailouts. In fact, the IMF's classic prescriptions have failed dismally in Asia and Russia alike. "The only way to help a country is by telling it to stand on its own two feet," says Albert D. Fried-

berg, director of Toronto-based money management firm Friedberg Mercantile Group. Friedberg believes that by bailing out first Latin America in the 1980s, then Mexico in 1994, and now Thailand and Korea, Western lenders have encouraged private investors to assume that they'll be protected if an emerging market goes under. "We have created a monumental moral hazard problem," he says, adding that bailouts help banks like Chase Manhattan Corp. and Goldman, Sachs & Co. more than the struggling economies in which they invest.

Currency and capital controls are also stopgap measures. They may keep hot money from flooding in



and out of countries, but they restrict the flow of long-term investment at the same time. And countries that adopt capital controls don't learn to cope with the normal fluctuations of supply and demand. "The longer controls are in place, the larger the disequilibrium and the larger the shock when it has to be corrected," says Donald P. Gould, a global asset allocator at Franklin Templeton Group in Claremont, Calif.

KINDEST CUT. The alternative to bailouts and prefabricated currency stability isn't pretty. It means punishing the fake capitalists and the investors who supported them. It means forcing government officials to

wean the oligarchs they have nurtured. It means ending jingoistic practices by opening jobs and markets to foreigners.

Truly free markets can also subject ordinary citizens to severe pain. Indeed, in the past, the U.S. and international lending organizations justified quick rescues for troubled economies by raising the specter of massive social unrest. Russia's crisis is already causing whispers in Washington about the global havoc that a broke and hungry nuclear power might wreak. Without question, the downside of letting the free market do its job is that hardworking people get hammered along with corrupt officials and high-rolling investors.

Yet in the long run, it would do errant countries a kindness to burst their speculative bubbles and dismantle their bankrupt corporations. They may become members of the free-market club reluctantly. But that's only because they haven't really learned that this is a club worth paying dues to join.



HONG KONG INVESTORS: An artificial market

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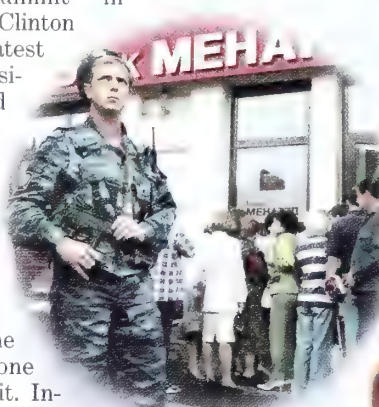
COMMENTARY

By Amy Borrus and Dean Foust

As he prepares for a Sept. 1 superpower summit in Moscow, Bill Clinton faces the greatest challenge of his Presidency. What had been a key foreign policy success—coaxing Russia into the global economic system—is quickly becoming a quagmire. And there appears to be very little the President—or anyone else—can do to fix it. Infusions of aid from international institutions have failed to bolster Russia's markets, and Clinton won't be writing any new checks. All Clinton can offer is advice. And it's not even clear—with Russian President Boris Yeltsin's grip on power shaky—to whom he can give it.

With 11,000 nuclear weapons, unstable democratic government, and resurgent ultra-nationalism feeding an anti-U.S. backlash, Russia again looms as a national security threat. And there's the rub: In his years in the Oval Office, Clinton has run foreign policy as if it were chiefly about opening world markets and integrating economies. When it comes to managing international crises with more conventional weapons of statesmanship, Clinton is a relative novice.

SPILLOVER? And Russia is hardly his sole headache. From bombings of U.S. embassies in Africa, to the chicanery of Saddam Hussein, to reports of a renewed nuclear buildup in North Korea, the world hasn't looked this scary since the cold war. Add to this mix the specter of meltdowns in such key markets as Japan and South Korea. The currency crises that sapped most of Asia and Russia now threaten to spill into Latin America and Eastern Europe.



RUSSIA'S ECONOMY is imploding, but the U.S. can do little to break the gridlock



TERRORISM Attacks on U.S. embassies and retaliatory strikes signal the start of a long war between the U.S. and Islamic terrorists



In the past, the world has looked to the U.S. to cure such ills. In turn, the President could seek help from other economic titans like Germany and Japan. At both Chancellor Helmut Kohl and Prime Minister Keizo Obuchi have their own local storms to weather. And because of the Monica Lewinsky scandal at home, Clinton's own political future is uncertain.

Sounds bleak. But there are steps Clinton can take. First, he must recognize that national security concerns can no longer take a back seat to international economics. "It's now clear we don't have a moment to relax," says Robert Kagan of the Carnegie Endowment for International Peace, a Washington think tank. "We have to both modernize our defenses for strategic threats 20 years out, and jump in to maintain a reasonable international order."

To do that, Clinton must strengthen connections with these bruised economies. Yet the first instincts of nations in trouble—particularly when they know Western bailout money is available—to turn inward. Witness Russia's decision to halt trading of the ruble and freeze payments on its government debt market—moves that could bring stability but also hurt future relations with foreign investors. With Russia threatening to implode, some outside advisers even pressed Clinton to cancel his trip.

IA Japan's recession is starting to hurt the U.S. and make it tough for other Asian economies to recover



But he rejected that advice. "To stay home would be unthinkable," says Anthony Lake, Clinton's former national security adviser. And given that the visit should bolster Russia's democrats, he made the right call.

Wall Street—with an eye to its hefty investment in Russian markets—has been clamoring for a new infusion of cash. But that would be throwing good money after bad. Indeed, Clinton already delivered that message to Yeltsin in an Aug. 25 phone call. "Additional money won't make things better—and might make them worse," says one senior Administration official. The Clintonites want reforms first, including better tax collection, a cleanup of Russia's corrupt banking system, stronger protections for investor rights, and further debt restructuring. Without this foundation, the Administration fears that Russia will squander more dollars and spook the markets even further.

MORAL AID. Besides, when it comes to the U.S.-Russian equation, Russia's economy—smaller than that of the Netherlands—is peanuts. What's really at stake is the stability of a country that still has a big nuclear arsenal and wields clout over many of the world's hot spots, from Kosovo to Khartoum. That's why Russia must once again be viewed as a national security concern—one that needs moral support—and not just another chip in the global economic mosaic. "We want to demonstrate that the relationship matters," says one senior official. "Sometimes, you just keep the agenda alive and moving."

Clinton's team will back up that goodwill with offers of technical support on such items as restructuring banks and converting military-grade plutonium to peaceful use. But Clinton would also be well advised to quietly reach out to possible successors to Yeltsin, such as Siberian leader Alexander Lebed, and Moscow Mayor Yuri

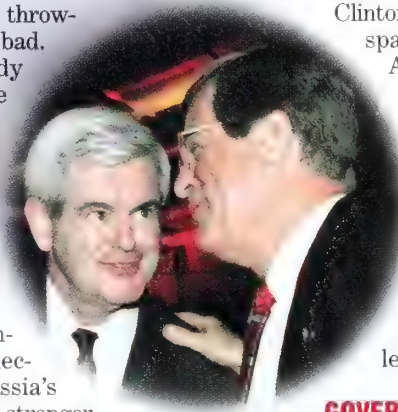
Luzhkov. "This is the beginning of the end for the Yeltsin era," says Russian scholar Alexander Rahr of the German Society for Foreign Affairs in Bonn.

Already, Clinton's team is mulling a U.S. Embassy party in Moscow where the President will be able to mingle with pools of all stripes, even as he seeks to buck up Yeltsin. That's a task tailor-made for the I-feel-your-pain President.

Clinton dare not fail. Treasury and Federal Reserve officials increasingly despair of Japan's will to fix its crumbling banking system. Japan is "the missing locomotive," says one

Clintonite. China, too, could spark a panic in dicey Asian markets such as Hong Kong if it devalues the yuan.

Restoring confidence in Russia is just one step toward stabilizing a dangerous world. Right now, that may be a lot to expect of a crippled leader who too often



GOVERNMENT FACE-OFF

Clinton and Congress increasingly are at odds over tax cuts, spending priorities, and health care



MONICA LEWINSKY Scandal has reduced Clinton's credibility and clout abroad

views the rest of the world as little more than a loading dock for U.S. exports. It's a challenge Clinton can't sidestep.

From Washington, Borrus and Foust write about politics and global economics.

DETROIT

WILL JAPAN SHAKE THE BIG THREE'S LAST STRONGHOLD?

A wave of powerful, feature-packed light trucks is on the way

C heryl LaBash is the kind of customer who makes Detroit execs lose sleep at night. She happily drove Japanese cars for 17 years until 1997, when she traded in her Honda Civic for a Plymouth Voyager. The 49-year-old Detroit construction inspector needed a roomier vehicle to haul her 100-pound Alaskan malamute and her work equipment. Honda Motor Co.'s CR-V sport utility was too small, so she paid \$16,000 for one of Chrysler Corp.'s popular minivans. But with Honda introducing a larger minivan, LaBash admits she still has a soft spot for Honda and could be won over again. "The Japanese vehicles have more amenities, and they are just more comfortable to drive," she says.

Watch out, Detroit. Here come the Japanese—again. The last bastion of Detroit dominance, light trucks, is under attack. A wave of new minivans, sport-utility vehicles, and pickup trucks from Japanese auto makers is about to encroach on Detroit's profit paradise. These new Japanese contenders pose an even greater threat than hot models such as the CR-V and Lexus RX 300 sport utes, which only nibbled at the edges of Detroit's truck stronghold. "They're going to give Detroit trouble," predicts Lehman Brothers Inc. auto analyst Joseph S. Phillippi. "Down the road, they will take a lot of share."

The onslaught will begin in October, when Honda launches the \$23,000 Odyssey minivan, aimed squarely at the top-selling Dodge Caravan and its sibling, the Voyager. Next spring, Toyota Motor Corp. will begin selling the Tundra, the first Japanese full-size pickup to

that were too cramped and lacked power. To name one example, the too-small Toyota T-100 in 1993. "I don't think those people understand the truck market," says Chrysler Chairman Robert J. Eaton. "They haven't come close yet."

But the Japanese, who have steadily captured nearly one-third of the U.S. car market over the past two decades, are now confident they can make a run at trucks. The new Toyota pickup will feature a brawny 4.7-liter V-6 engine. And Honda's Odyssey equals the Caravan in size and offers a more powerful V-6 engine, and has a third row of seats that tucks neatly into the floor to expand cargo room. "Everybody knows how good the Caravan is, but Honda's image is pretty good, too," says Thomas Elliott, American executive vice-president for sales.

Honda and Toyota will start small. Honda plans to sell only 70,000 Odyssey minivans next year—a pit-



The Competition Takes on Detroit

	HONDA ODYSSEY	VS.	DODGE GRAND CARAVAN	TOYOTA TUNDRA	VS.	FORD F-SERIES PICKUP
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WIDTH	75.6 inches		76.8 inches	75.2 inches		78.4 inches

*ESTIMATED PRICES

DATA: AUTO COMPANIES

spar with Detroit's sales stalwarts, the Ford F-series, Chevrolet Silverado, and Dodge Ram. And in 2000, Honda and Toyota will both launch roomy sport utilities that analysts say could give Detroit a run for the real money.

FAT MARGINS. In this contest, Detroit has a lot to lose: It derives virtually all of its automotive profits from sport utilities, minivans, and pickups. Margins on chrome-laden SUVs can run to \$15,000. Phillippi figures Ford Motor Co. pocketed nearly \$2 billion in profits last year just from the Ford Expedition and Lincoln Navigator sport utilities.

Detroit auto chieftains promise to protect their commanding 85% share of the lucrative truck market. And they do not fail to note that Toyota and Honda have flopped before with minivans and pickups

tance compared with Chrysler's 500,000 annual minivan sales. And Toyota is planning only 100,000 Tundra sales in the first year—just 14% of the annual sales of Ford's F-series pickup.

But that deliberate approach is deceptive. Toyota has invested \$1.2 billion in a new plant near Evansville, Ind., to build the Tundra, and in 2000, a big sport utility. And Honda invested \$200 million to build a new factory in Alliston, Ontario, next to its existing Civic plant, to produce the Odyssey and a sport ute known as the MAV, also coming in 2000. Combined, those two plants could be pumping out a half-million minivans, pickups, and sport utilities within three years.

Honda and Toyota have already scored small but significant victories in

A black and white photograph of a woman in a crowd, looking upwards and to the side while holding a mobile phone to her ear. She is wearing a strapless top and a watch. The background is blurred, showing other people in the crowd.

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sport utilities. They created a new market for car-based sport utes over the past two years with the hot-selling Honda CR-V and Toyota RAV4, which combined are on pace to sell more than 150,000 units this year. And the best-selling model for the past four months in Toyota's Lexus luxury line is the new RX 300 SUV, now selling at an annual rate exceeding 50,000. "People are trading in Jeeps and getting on the waiting list for the Lexus," says East Hanover (N.J.) car dealer Peter Jarvis.

Detroit dismisses Japan's SUVs as

"niche vehicles," but it is firing back with new models of its own. Chrysler is launching an overhauled Jeep Grand Cherokee, but instead of jacking up the price, it actually cut it by \$250 to start at \$26,220. General Motors Corp.'s most important new model is the \$15,995 Chevrolet Silverado, packed with new features but just \$340 more than the 11-year-old model it replaces. And Ford is adding a fourth door to its Windstar minivan and the extended-cab F-150 pickup. "We intend to keep ahead of the game," pledges Richard Parry-Jones,

Ford's group vice-president for product development.

But Detroit has fallen behind before. That's why America's two top-selling cars are the Honda Accord and Toyota Camry. "Once the reputation gets out of the Tundra," says Don Esmond, group vice-president for the U.S. Toyota Division, "it will be just like the Camry." That might seem a distant prospect to content Motown execs. But if it comes pass, it would be their worst nightmare.

By Keith Naughton, with Kathleen Kerwin, in Detroit

DEALS

TELLABS HAS A REALLY BAD DAY

Its bid for fiber-optic company Ciena is in peril

For years, Tellabs Inc. has been one of Wall Street's favorite over-achievers. The telecom equipment maker could do no wrong as it pushed into overseas markets, acquired several competitors, and kept revenues growing at a 30% annual clip. But suddenly, its future as a telecom behemoth is at risk.

Tellabs' most important deal to date, a one-for-one stock swap with Ciena Corp., is in jeopardy. On Aug. 21, AT&T unexpectedly dumped Ciena as a potential supplier. The news sent Ciena's stock plunging 45%, from \$56.78 a share to \$31.25. It later recovered only slightly, closing at \$34.25 on Aug. 26.

The setback raises questions about the quality of Ciena's main product, which multiplies the bandwidth of fiber-optic cables. And it casts doubt on the wisdom of Tellabs' merger decision. Still, Tellabs CEO Michael J. Birck faces a thorny dilemma: Knowing that others may be interested in Ciena, how hard should he fight to keep the deal?

CISCO TALKS? With investors waiting impatiently, the Tellabs board huddled for more than six hours on Aug. 25 at the company's suburban Chicago headquarters. Birck was unavailable for comment, but sources close to the talks expect Tellabs to offer Ciena shareholders about three-fourths of a Tellabs share for every Ciena share, making the deal worth close to \$5 billion, down from the original \$7.1 billion.

Though Ciena has said the loss of AT&T won't significantly affect earnings, analysts say a discounted bid makes sense. Not only has Ciena lost AT&T, but it also

faces new competition that could lure away longtime customers like WorldCom Inc.

Pursuing the merger with Ciena also makes sense for Tellabs, which makes equipment that connects digital networks. Tellabs needs to diversify its product line, and Ciena will help it move into the fiber-optic arena. Says John B. Leo, vice-president of the Northern Trust Co., a Tellabs shareholder: Without Ciena and its technology, Tellabs' growth "might otherwise slow."

So the risks of a lowball offer are huge, warns Michael Davies, a telecommunications networking analyst at Punk, Ziegel & Co. in New York. Ciena already has been approached by a second suitor. On May 6, a month after Tellabs began its formal talks, Ciena reported in a proxy statement that an unnamed company had expressed interest in it. That company, several analysts say, was Cisco Systems Inc. A Cisco spokesman calls Ciena's wave division multiplexing (WDM) product, which allows networks to carry 40 times their normal amount, "an important technolo-

ILL-FATED?
CEOs Birck of Tellabs (left) and Nettles of Ciena hoped to build high-capacity telecom networks

gy," but he wouldn't comment on a bid for the company.

Cisco may not be the only suitor that has looked Ciena over either. Analysts agree Ciena would fit nicely with German electronics giant Siemens or network equipment maker Ascend Communications. Both refuse comment on bidding, and a Siemens spokesman says the company will introduce its own, low-end WDM product in mid-September.

Even so, analysts see a Ciena acquisition as a way for Siemens to reel in such U.S. heavyweights as Sprint Corp. and WorldCom. For Ascend, it's the "next logical step," says Timothy J. Smith of tech research firm Dataquest Inc. Ascend, based in Alameda, Calif., also makes digital switches but lacks the kind of optical equipment Ciena makes.

No doubt, Birck and his board are sweating over the risk of getting trumped. But to keep Wall Street applauding, Birck knows he has to keep finding more cards up his sleeve.

By Roger O. Crockett in Chicago with Andy Reinhardt in San Mateo



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THE ECONOMY

HOMES ARE SELLING LIKE A HOUSE AFIRE

It's a record year for developers. But will they overbuild?



If you have any doubt that Americans have a near-insatiable urge to buy a new home these days, just ask any developer. One rainy, 90-degree-plus night in July, dozens of potential buyers camped outside a Centex Homes sales office to get first crack at a 20-lot expansion of a 300-home subdivision in suburban Dallas. At a new Naples (Fla.) development, the same company is asking—and getting—up to \$320,000 for homes that won't be available before July, 1999. And by mid-August, Monterey Homes Corp. had already received 1,400 inquiries for a scant 17 new homes in Rocklin, Calif., that won't even go up for sale until mid-September. "It doesn't get any better than this," says Centex Chief Financial Officer William D. Albers. "This is one of those times when all the stars are in alignment."

BULL RUN. And it doesn't take an astrologer to see all factors pointing to the best annual performance for home construction since the go-go '80s. Credit a strong economy, low mortgage rates, rising incomes, and strong consumer confidence for pushing housing starts to their brisk pace in 11 years. In July, says the Commerce Dept.,

NAILING IT: A house rising in Texas adds boost to a banner year

starts were up 5.7% to a seasonally adjusted annual rate of 1.7 million units.

Sales of existing homes are setting records, too. On Aug. 25, the National Association of Realtors reported a 4% jump in July sales of previously owned single-family homes, to an annualized 4.93 million units, the highest level ever. Not surprisingly, the frantic pace of home buying has pumped up prices more than 6% in a year when inflation can't crack 2%. In 52 years in the business, "I've never seen a market this strong," says Donald F. Horning, president of Brookfield (Wis.)-based Shore-West Realtors Inc., where pre-July unit sales were up 23% over last year.

Just how long can this bonanza last? "The end is not in sight," says David Lereah, chief economist at the Mortgage Bankers

Assn., who sees six to 12 months more of bounce ahead—as long as interest rates stay at current low levels. The scenario may be too rosy. Mark M. Zandi, chief economist at housing consulting firm Regional Financial Associates Inc., says that in most of the country—except for pockets in Texas, Florida, and California—pent-up demand has been nearly met. "We're working on spent demand," says Zandi, defining that second- and third-time homeowners going bigger with gains made in the stock market or from selling their own home.

Some economists even see the potential for a slowdown by yearend as layoffs at U.S. factories rise due to Asian woes. "Even if interest rates are low, a worker loses his job, that person is not going to be buying a house," says Paul L. Kasriel, chief U.S. economist at Northern Trust Corp. in Chicago.

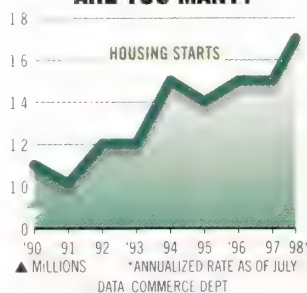
TAPPED OUT? But so far, Asia has only helped builders. Raw material prices on such items as lumber and roofing supplies have cut construction costs significantly. Still, home developers aren't necessarily enjoying significantly wider margins. Many—especially smaller and midsize builders—report serious labor shortages, particularly for such skilled workers as carpenters, framers, and masons. They also are having to pay top dollar for those workers they can hire. A Charleston (S.C.) builder Barkley/Fraser Co., labor costs have risen about 10% over the past two years. One solution: out-of-state labor pools. But now even those markets are "tapped out," says Barkley/Fraser co-owner Chris Fraser.

Yet whether or not their costs are rising, developers—and other sellers—are boosting prices. In Atlanta, Colony Homes prices are up as much as 7% in the past year. Nationwide, Centex has jacked up prices by at least 10% in the past six months—in some instances to discourage demand, says Albers. And these steep hikes could do just that—but maybe too soon and by too much.

That could be a problem for those still building new homes. RFA's Zandi says there could be 300,000 excess homes added by yearend if the boom continues. Time to quit? Maybe. But if history is guide, developers will have trouble quelling those speculative juices.

By Stephanie Anderson
Forest in Dallas, with bureau reports

HOW MANY NEW HOMES ARE TOO MANY?



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COMMENTARY

By Aaron Bernstein

A HUMAN REASON NOT TO RAISE RATES



TYPING POOL: Did money policy aggravate the gap between rich and poor?

When central bankers from around the world gather at the Federal Reserve Board confab in Jackson Hole, Wyo., starting on Aug. 27, Russia's collapsing economy is likely to be the hottest topic at the dinner tables. But that won't stop talk about the subject closest to these bankers' hearts: monetary policy. Key to that debate are today's low jobless stats and the fat wage gains they have provided. Indeed, at the July Fed meeting, hawks called again for a rate boost to cool off the steady ascent of real wages.

In this context, the official subject of the three-day meeting, income inequality, offers a timely opportunity for Fed bankers to review their approach to monetary policy. In recent decades, the Fed has focused on controlling inflation, paying far less attention to its other legally mandated job—curbing unemployment. Liberals often slammed the central bank for this neglect. But even they didn't blame the Fed for 25 years of a widening gap between rich and poor—through recessions and boom times alike.

Now, some liberal economists are arguing that Fed monetary policy may have indeed aggravated the disparity after all. The reason: signs that the gap between rich and poor is finally narrowing, just as the Fed

has stopped itself—uncharacteristically—from pushing interest rates up as the jobless rate lingered below 5% for the first time since the 1960s. As one consequence, wages for the bottom 20% of workers have risen by a real 3.6% a year since June 1996, while wages of those in the top 10% rose 2.3%. Liberal economists such as James K. Galbraith of the University of Texas say the Fed should be pleased: It is only at unemployment levels like today's that demand for less skilled workers is great enough to lift up their wages. It shows that "there's plenty the Fed can do about inequality, namely, to keep unemployment and interest rates low," says Galbraith, the author of a new book called *Created Unequal: The Crisis in American Pay*.

The clash between liberals and Fed bankers will resurface if prices start to creep up again. After all, the Fed has not refrained from hitting the brakes out of concern about inequality. For now, Chairman Alan Greenspan believes that inflation is being held at bay by

long-term changes in the economy, such as technological advances. His opinion has outweighed Fed hawks who, in contrast, believe that inflation is on hold simply because of temporary factors such as low commodity prices and Asia's turmoil.

The question bankers should debate in the Tetons is whether the economy can tolerate a jump in prices from what are probably unsustainably low levels—particularly for such items as oil. Hawks will step up demands for rate hikes if that happens. But Greenspan may want to wait and see if inflation simply rebounds to a still-acceptable level.

POWERFUL REASON. This is where inequality enters the policy equation. If liberal economists are correct about the need to keep unemployment below 5% to help the bottom half of the workforce, then the Fed would have a powerful new reason to hold back—even with some price inflation—on rates. The long-term benefit of reversing 25 years of growing inequality might be worth it.

The trick would be to make sure that the bond market doesn't panic while the Fed waits. This may be easier to pull off now that Greenspan has managed interest rates so well. Just a few years ago, the hawks argued that if unemployment fell below the so-called natural rate of 5%, the Fed would lose its ability to avert an inflation spiral. As this hasn't happened, the fear of a trigger point "is more or less gone at the Fed," says Alan S. Blinder, a former Fed vice-chairman

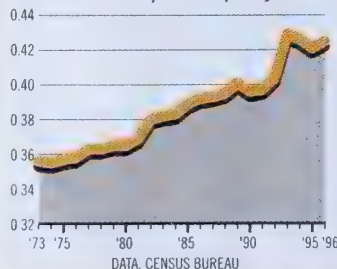
and Princeton University economist.

While the fate of Russia is a sizzling issue, there's not much Fed bankers can do about it. But there may be something they can do about inequality. And that's worth talking about in the mountains of Wyoming.

Bernstein covers labor from Washington.

WAGE INEQUALITY LEVELS OFF

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EDITED BY KELLEY HOLLAND

BRITISH AIRWAYS SNUBS BOEING

BOEING SUFFERED A BLOW ON Aug. 25 when British Airways decided to order 59 short-haul aircraft for a list price of some \$2.6 billion from Airbus Industrie, its first deal with the manufacturer. Chris Avery, an analyst at Paribas in London, thinks BA is getting the planes at as much as one-third off list price. But Boeing, which did get firm orders from BA for 16 777s for a price of about \$2.4 billion, may still regret losing the bigger order. It boosts Airbus' prestige and the odds that BA will sign up for its proposed A3XX transport, which threatens Boeing's 747. The deal preserves some

39,000 British jobs, many of them at engine maker Rolls-Royce and British Aerospace, a member of the Airbus consortium.

HUGE LAYOFF AT HARNISCHFEGER

MORE BACKWASH FROM OVERSEAS turbulence: Mining and paper equipment maker Harnischfeger Industries is cutting 20% of its workforce in the wake of a third-quarter loss of \$38 million. The miserable results stem partly from slowing demand for its capital equipment in Asia and other emerging markets. Management has been mulling moves to enhance shareholder value, but now pressure is intensifying: Trinity Fund, an investment partnership that includes the Bass family and holds 6.2% of Harnischfeger shares, is "very disappointed," a spokesman says, and is considering its options.

CLOSING BELL

AUTO WRECK

Autodesk's stock is plunging—and CEO Carol Bartz calls it a "total overreaction." The shares fell 21% on Aug. 21 after a warning that second-half earnings would be hit by slower sales in Asia. You can't blame Bartz for griping: Second-quarter total revenue rose 21%, even though Asian sales were down 26%, and operating earnings rose 56%. Analysts see pluses in Autodesk's \$520 million purchase of Discreet Logic and an upgrade of AutoCAD, its mainstay engineering program.



MARSH & McLENNAN: BIG GETS BIGGER

DOES BIGGER INSURE YOU'RE better? Marsh & McLennan clearly thinks so. The world's largest insurance broker said on Aug. 25 that it would buy the third-biggest insurance broker, Britain's Sedgwick Group, for around \$2 billion. Marsh would pay 225 pence a share for Sedgwick, a 58% premium over the British broker's share price the day before the deal was announced. Even by Marsh's reckoning, the deal won't add to its earnings until 2000. But senior managers believe Marsh will get more efficient the bigger it gets.

MICKEY BUCKS FOR HOCKEY PUCKS

HOCKEY'S TV RATINGS MAY BE falling, but that isn't stopping Disney, on behalf of its ABC

HEADLINER: KENT KRESA

THE BEST DEFENSE IS A GOOD OFFENSE

In the past year, Northrop Grumman Chairman Kent Kresa has been preoccupied by his company's planned merger with Lockheed Martin. The deal would have cost Northrop its independence but resurrected it as a prime defense contractor. Now that the Justice Dept. has torpedoed the deal, Kresa, 60, must focus anew on his company.

On Aug. 24, Kresa announced a restructuring that will keep Northrop independent—albeit as more of a subcontractor of electronics and information systems to the likes of Boeing, Lockheed, and

Raytheon. Los Angeles-based Northrop will slash its workforce by nearly 15%, to 46,000, by 2001 and take a \$60 million charge this year. Northrop expects the moves to boost operating margins to 12.5% by the end of 2000, from 10% in the first half of '98. "It's finally an acceptance internally that they can compete very successfully not as a prime, but as a principal subcontractor," says Renee J. Gentry, senior analyst with the Teal Group in Fairfax, Va. To "survive and thrive," Kresa says he has no other option.

By Steve Brull



network and ESPN cable channels, from signing a five-year, \$600 million deal with the National Hockey League that begins with the 1999-2000 season. The TV rights package, announced on Aug. 25, is nearly triple the amount that ESPN and News Corp.'s Fox Sports paid for the five years beginning in 1994 and ending in the upcoming season. Both suffered double-digit ratings losses in the most recent season. So it wasn't surprising that Fox didn't try to match Disney's bid; in fact, sources say it has been losing as much as \$1 million a broadcast and has been trying to wriggle out of its final year.

ELVES NAB THE GIRL SCOUTS

LOOKS LIKE THE KEEBLER elves will be busy making Girl Scout Cookies. Keebler Foods is inking a \$450 million deal for President Bak-

ing, supplier of 60% of the nation's Girl Scout cookies and Famous Amos brands. The deal, which should add to earnings in 1999, will give Keebler a share of the sugar-free cookie market and provide it with added shelf space in convenience stores and vending machines. Keebler says sales at the privately held bakery topped \$450 million in 1997. That should help Keebler boost its current 24% share in the \$8.3 billion cookies and crackers market.

ET CETERA...

- Novartis is merging its OTC medication and nutrition businesses.
- Quark made an offer for Adobe Systems, but Adobe is rejecting the bid.
- Philip Morris will raise its quarterly dividend for the first time since October, 1996.
- Losing a stitch: Shares of St. John Knits fell 30% on a profit warning.



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EDITED BY DOUGLAS HARBRECHT

VILL CLINTON BE FORCED TO TILT TOWARD THE LEFT?

As the summer of Bill Clinton's discontent wound down on Martha's Vineyard, the beleaguered President had plenty to think about while he waited for Hurricane Bonnie to ad up the coast. How serious a threat is Independent Counsel Kenneth W. Starr's reported decision to charge him with a wide-ranging abuse of power? Can he trust House Speaker Newt Gingrich's vow that only a pattern of felonies, rather than a single lie about a sexual escapade, would be grounds for impeachment? And will he be able to defrost relations with his icily outraged Democratic allies?

For Clinton these days, there are far more questions than answers. The most useful of them awaits his return to Washington on Aug. 30: Can a President who is viewed as a superb economic steward but a weasel when it comes to ethics salvage any semblance of moral clout? The answer will determine how Clinton handles key domestic policy choices headed his way as Congress races through an end-of-session legislative flurry.

During Clinton's vacation, aides been debating ways to shore up their base's political support in the face of growing Republican threats to officially censure him. Some political advisers urge an avid courtship of Hill Democrats that would include a legislative tack to the left on issues important to business. But that means Clinton would have to suppress his natural tendency to compromise with the GOP.

Clinton's centrist policy works counter that such a shift courts disaster. It would sacrifice his New Democratic legacy—fiscal restraint, welfare reform, and a robust business climate—in a short-term quest for support. "It buys him nothing but start acting like Ted Kennedy," says one outside adviser to the White House. "How many liberals are left in the country?" Maybe not many. But there are plenty in Congress. And

they may be sending Clinton a none-too-subtle message. Senate Minority Leader Tom Daschle of South Dakota voiced sharp disappointment with Clinton after his weak Monica apology. And on Aug. 25, House Minority Leader Richard A. Gephardt of Missouri went a good deal further when he left open the possibility of impeachment.

One of the ways Clinton can encourage liberals to stand with him is to stand with them in the drive for a powerful patient "bill of rights." Clinton prodded Congress so often to move on the issue that a worried GOP has produced its own tepid pack-

age of patient protections. In the past, the Prez's pragmatism would lead him to cut a deal. But liberals want the legislation to die so they can accuse Republicans of kowtowing to the brutes of managed care. They fear that Clinton will neutralize their top campaign weapon.

TAX AMMO. Clinton will face a similar problem with tax policy. Many liberals oppose the GOP push for tax relief. Clinton hints that he could accept a tax cut of about \$70 billion over five years in exchange for restored funding for his education initiatives. But liberals would prefer to go into the elections with the



TEPID ALLIES: With Gephardt, Daschle

White House bashing Republicans for proposing billions in "irresponsible" tax cuts that put Social Security at risk.

Will Clinton's woes compel him to reemerge as a lefty to ingratiate himself with party regulars? True, the man has the strongest survival instinct of any politician in memory, and he has zigzagged from left to right before. But, say his friends, at his core Bill Clinton remains an instinctive New Democrat—one reluctant to change sides now. Besides, in the battleground that has become the Clinton Presidency, it's a bit late for a foxhole conversion.

By Lee Walczak, with Howard Gleckman and Mike McNamee

CAPITAL WRAPUP

ALARM OVER THE BELLS?

► The Federal Communications Commission is ready to approve the \$37 billion WorldCom-MCI Communications merger, now that MCI has agreed to sell its Internet business to Cable & Wireless. But trustbusters are worried about a shrinking pool of Baby Bells and other providers of local phone service. The FCC has a wary eye on both the SBC Communications-Ameritech merger and the Bell Atlantic-GTE deal. Sources say it may consider blocking them.

CAR TALK

► A merger is in the works between the American Automobile Manufacturers Assn. and its longtime nemesis, the Association of International Automobile Manufacturers. Why? The Big Three will become the Big Two in December when Chrysler Corp. joins Germany's Daimler Benz, making Detroit's No. 3 carmaker ineligible for AAMA membership. Lobbyists want a megagroup with more clout to address Hill auto issues such as air bags but avoid hot subjects such as trade policy.

HENNEY ON THE HOT SEAT

► Dr. Jane E. Henney has boosted her chances of becoming head of the Food & Drug Administration. In 71 pages of responses to questions from the Senate Labor & Human Resources Committee, she skirted issues like tobacco and the abortion pill. And she appeased industry by vowing to implement last year's FDA reforms. But her confirmation hearing in early September won't be a cakewalk. Expect Henney to undergo a grilling, especially about drugs for children and standards for medical devices.

It's a sign of desperation and, normally, an act of last resort: A government sees local stocks tumbling and intervenes to prop up prices. Except that Hong Kong, where that has been happening steadily through the last half of August, is supposed to be a hands-off kind of place. But by throwing an estimated \$3 billion in foreign reserves at speculators to fend them off, Hong Kong has shown that it's afraid of what those betting against the Hong Kong dollar could do to the economy. And that has perversely encouraged the speculators to keep attacking all the more—with increasing effectiveness. "Hedge funds smell blood," says Cliff Tan, a Singapore-based foreign-exchange analyst at Warburg Dillon Read.

It's possible they'll get it. At the heart of this uproar is the government's pledge to keep its currency pegged to the U.S. dollar. If the peg breaks, say authorities, chaos will follow. The Hong Kong dollar might tumble as much as 40%, like other Asian currencies. Then, all bets are off that China will be able to withstand devaluing its currency, too. Further devastating currency devaluations in Asia would follow. Traders don't care: In August, the Hong Kong Monetary Authority said hedge funds were deliberately trying to crash the stock market by launching an all-out attack on the peg. So it slammed them to wipe out the short positions they had taken in equities. Tough stuff. Yet as a result, the government may have greatly boosted the chances that the peg will go—and with it, the foundation of the Hong Kong economy.

FOUR OPTIONS. Why? In the end, no government can withstand month after month of attacks on its currency and bourses if it is resolved to strike back through interventions. Eventually, that depletes the treasury, plentiful as Hong Kong's is. "Before this intervention, and before the turmoil in Russia, I wouldn't have even questioned the government's commitment to the peg," says a Hong Kong-based analyst for a prominent U.S. investment bank who has moved his money out of the Hong Kong dollar. "Now, the probability of something happening with the currency, such as a 40% devaluation, has increased dramatically."

The peg may not go quite yet. As it stands, Hong Kong has four options with its cur-

rency, all of them far from perfect. It could release the peg and let the Hong Kong dollar float freely. It could continue to stick with the peg and hope speculators are sufficiently unnerved by its tactics that they figure it's too risky to keep attacking the currency. It could go the drastic route of dollarizing its economy—making the U.S. dollar legal tender. Or, finally, it could repeg the dollar at a rate lower

than the current 7.8 to one greenback.

Each of these options is fraught with problems. If Hong Kong stays the course, interest rates will stay high; property and stock prices will keep getting hammered, and unemployment will keep rising. Although both stocks and real estate have fallen about 50% in the past year, analysts say there's still a long way to go. Morgan Stanley Asia Ltd. says residential property prices still need to drop 40% to 50% more from present levels. As property prices fall, so does the Hang Seng, which is dominated by property-linked companies.

Dollarizing the currency would leave

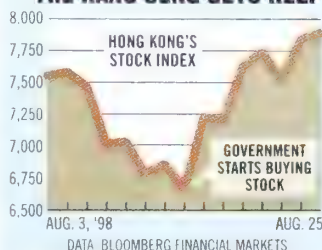
CURRENCIES

A HEAVY HAND

The ill effects of government market



THE HANG SENG GETS HELP



HONG KONG

intervention will be felt for years



aders nothing to attack, and it might stabilize things. Yet the move would be politically unpalatable to Beijing, which took control of Hong Kong last year. Accepting the greenback as legal tender on Chinese soil would be a bitter pill to swallow. Other issues: Hong Kong would have to raise \$115 billion from China elsewhere to cover every Hong Kong dollar in circulation. Dollarization also isn't guaranteed to bring down interest rates. With the economy stalling, credit risk remains high—and so could rates. Although the government denies it, market sources say Hong Kong's elite Monetary Policy Unit is at least explor-

ing dollarization with Washington.

Letting the currency float freely or repegging it to the U.S. dollar at a lower rate might help ease the pain by making local stocks and properties cheaper to international investors. Or it might not. Interest rates might rise in response to the increased volatility, as they have done throughout emerging markets in the past year. And keeping a peg at all might keep attracting attacks.

Still, some investors think a repegging is the most sensible way to let the economy adjust. That would make wages more competitive internationally. "The best thing that can happen is to

realign the peg," says Jim Mellon, chairman of Hong Kong-based fund manager Regent Pacific Group Ltd. "Asset prices are adjusting, but wages are not. You either need to cut the currency or be willing to accept mass unemployment."

Whatever happens, it is going to take Hong Kong years to overcome the effects of its recent interventions. In a sentiment typical of many, a Hong Kong-based international fund manager derides the "Mahathirization" of the Hong Kong economy, a caustic reference to Malaysian Prime Minister Mahathir Mohamad's distrust of markets and his heavy-handed attempts to prop up local companies. Indeed, Mahathir is the only international leader who has spoken out in favor of Hong Kong's intervention, saying it has proved his point about the power of hedge funds.

Hong Kong's leaders insist that nothing has changed. "The only objective is to eliminate the manipulation," says Esmond K. Y. Lee, the New York representative for the Monetary Authority, and to "restore the intrinsic value of shares, to make them more in line with economic reality and the fundamentals."

WIDESPREAD PAIN. Meanwhile, the damage is spreading. Rising rates are hitting smaller banks and property players hard. Loans tower over the Hong Kong economy at a rate of 150% of gross domestic product—one of the highest ratios in Asia. That means a lot of people get hurt by a rise in interest rates.

Consumers are cutting back drastically. Retail sales are down 15% so far this year, and stores all over Hong Kong are going bankrupt. The feeling in Hong Kong is that the local business community, led by property developers, is pleading with Hong Kong Chief Executive Tung Chee-hwa to protect their interests. "The pain is leading people who have the ear of Mr. Tung to pressure him into doing something," says Merrill Lynch & Co. Vice-President Richard Margolis. "He is responding to that pressure."

Government officials strenuously deny that they are in the pocket of the property barons. They point out that the HKMA is buying all kinds of stocks, not just property. "The government has to take some decision to guard the public interest," says David K. P. Tsui, director of the Hong Kong Economic & Trade Office in New York. The question is whether clumsy market manipulation truly serves the public interest in a place that holds itself up as a model economy. The betting is that it doesn't.

By Mark L. Clifford in Hong Kong, with Sheri Prasso in New York

COMMENTARY

By Moon Ihlwan

KOREA INC. WIMPS OUT AGAIN

Korea's industry is sending a scary message: It cannot fix itself. If that's true, then the implications for the country's recovery are deeply alarming.

Recent events in South Korea's auto industry highlight this inability to restructure. One is the end of union protests over layoffs at Hyundai Motor Co. on Aug. 24, thanks to a compromise between management and labor. Another is the auction of bankrupt Kia Motors Corp. set for Sept. 1. On the surface, both developments sound promising: Layoffs and forced sales look like the painful steps the industry needs to take. Korean auto makers suffer from a serious capacity overhang, too much debt, a 50% drop in sales, and some \$5 billion in collective losses so far this year. So drastic action is necessary.

But take a closer look at these events and you see massive resistance to change. First, the Hyundai strike. For more than a month, thousands of pipe-welding workers blocked the gate of the Ulsan plant of Korea's No. 1 carmaker with gasoline-filled containers and brand new sedans. Production was at a halt until mediation by Labor Minister Lee Ki Ho and the ruling party finally averted a bloody confrontation.

OMINOUS SIGNAL. Hyundai wanted to lay off more than 1,500 workers. Yet the compromise forces it to lay off only 277—almost two-thirds of them female cafeteria employees. The company should be shedding thousands of workers even after losing about 6,000 employees to early retirement schemes and unpaid leave. Hyundai Motor has almost half the workforce of Toyota Motor Corp. but barely one-tenth of Toyota's revenues.

So the settlement sends a signal to the *chaebol*: Mass layoffs are off-limits, and recent legislation permitting firings is essentially a dead letter. Investors had optimistically predicted a wave of corporate down-



MILITANT LABOR: A striker at a Hyundai plant

sizing in the fall—provided Hyundai had carried through. Now, says Mark Neale, head of research at Dresdner Kleinwort Benson in Seoul, “the whole process will be slowed.”

Then there's the auction of Kia and its truckmaking affiliate, Asia Motors. The big question is whether Ford Motor Co., the only major foreign bidder, will be allowed to take control. “That will mean the start of free-market competition in Korea,” says Cho Dong Sung, economics professor at Seoul National University. Such a development would deal a major blow to Korea's traditional protection of local industry, which helped the *chaebol* to expand reck-

lessly into profitless businesses.

But the auction has taken an unsettling turn. Korea's auto makers are in no position to buy Kia: The industry has \$25 billion in debt to worry about already. Realistically, only cash-rich foreign companies such as Ford should be bidding. Instead, Hyundai and Daewoo, are bidding furiously to keep Ford out of the local market. Samsung's in there too: The speculation is that its auto subsidiary, whose first car rolled out in March just as the market collapsed, will have to exit the industry if it cannot take over Kia. Yet it's unclear how any of the Korean carmakers can afford this acquisition. What is clear is that by bidding, the *chaebol* chiefs are going back on recent promises to act prudently and avoid dicey expansion plans.

Ford, meanwhile, wants the Korean government to assume the bulk of Kia's \$9 billion in debt if it wins the bid. That's an understandable position for Ford to take. But if the govern-

ment does assume the debt, it removes much of the pressure to shut down assembly lines at Kia to save money. Given the parlous state of the local auto industry, some shutdown in capacity is absolutely necessary.

The most discouraging thing about the situation is the role played by the government. Instead of pressuring Hyundai to minimize layoffs, the government of President Kim Dae Jung should have been thinning the ranks of the bureaucracy to convince the public that it is distributing the pain equitably, and so set an example for Hyundai's unions. At Kia, which has been in court receivership for a year, the authorities should have moved much faster to shut down surplus plants and limit bidding to well-financed buyers. But Korea's leaders in government and industry keep trying to avoid the pain. And so the pain just gets worse.

**Hyundai will end up
laying off 277 workers
—instead of 1,500**

*Moon covers Korea's economy for
BUSINESS WEEK.*

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CURRENCIES

WHY CENTRAL EUROPE LOVES THE EURO

The new currency will streamline trade and banking

Prague's Komerční Banka is revamping its software and training staff so that it can sell products based on the European Union's common currency, the euro. In Győr, Hungary, home textiles maker Graboplast, which exports 22% of its \$67 million annual sales to the EU, plans to set its prices in the new unit. "We have a great price advantage, and [the euro] will make it easier for our marketing guys to make that clear," says Graboplast Chief Financial Officer Tibor Bori.

Central Europe is in the grip of euro fever. Policymakers, bankers, and executives are racing to prepare themselves for the euro's introduction next Jan. 1, when 11 EU nations will form the European Monetary Union. Even though countries such as Poland and the Czech Republic are not part of EMU, the euro will have a major impact on them. "EMU provides a very important anchor for Central Europe," says Bart Turtelboom, senior economist with Deutsche Bank Securities in London.

NEW HEDGE. The euro's launch will force some quick changes in Central Europe. For starters, two-thirds of the region's \$110 billion in annual trade is with the EU. So, potentially, companies can save a bundle on currency hedging if they invoice in euros. Polish TV maker Thomson Polkolor will be doing just that on \$176 million in annual exports to the EU. "It should streamline our [foreign

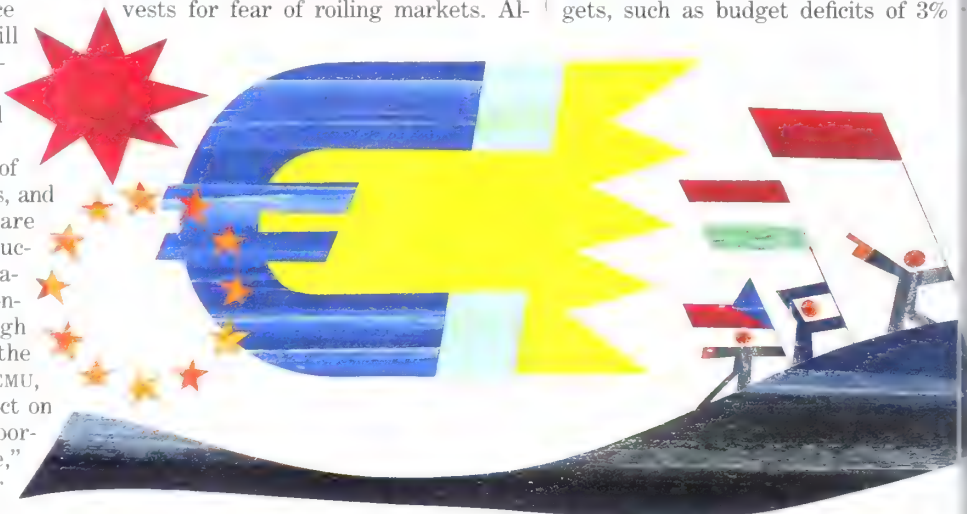
exchange] operations," says Chief Financial Officer Stanley W. Urban.

The region's central banks also face some tough decisions on the baskets against which they peg currencies. Hungary, for instance, uses the German mark and the dollar. Central bankers are playing their cards close to their vests for fear of roiling markets. Al-

be able to join the EU in 2002 as they once hoped.

Whatever Central European countries decide, their financial markets are likely to become more volatile. As EMU interest rates settle around 4.5% on 1-year government bonds, money managers could flock eastward for far higher rewards such as the 22% yield on equivalent Polish bonds. A big cash influx could easily force rates down fast, and currencies much higher, than the local authorities want. And with few European currencies to play with, speculators may be tempted to gamble on the Czech koruna, which floats freely.

TOUGH NUT. Countries that stick to the rigorous discipline the EMU imposes on aspiring members stand to gain the most. Several are now hitting some targets, such as budget deficits of 3%



most certainly, though, they'll beef up the euro content. After all, it makes little sense for Poland to peg its zloty to a five-currency basket that is 45% dollars when it mostly trades with the EU.

Governments could use such technical decisions to reaffirm their eagerness to join the EU. When they're admitted, they will have to join an exchange rate mechanism and keep their currencies within a fixed band against the euro.

Even before then, a heavier euro weighting in their currency baskets would hitch Central Europe's economic fate much more tightly to the EU. Such a gesture might appeal to Poland, Hungary, Czech Republic, Estonia, and Slovenia now that they realize they will not

less of gross domestic product (change) and debt no more than 60% of GDP.

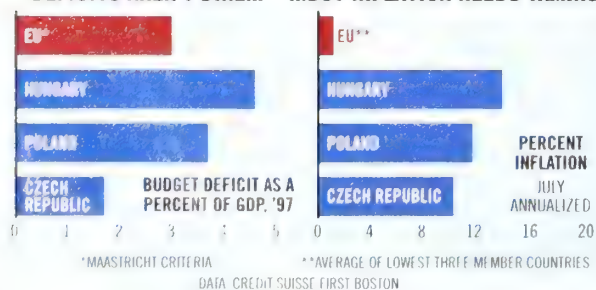
But inflation remains a tough nut to crack. The European Central Bank will require countries joining the EMU to have inflation rates no more than 1 percentage points above the average of those three EU members with the lowest levels over the previous two years. Poland, for example, will have to slash its 12% rate to below 3% by about 2000. "We take the ECB [goal] as a strategic target to plan our policy," says Ryszard Kokoszczyński, deputy governor of the National Bank of Poland.

Central European countries won't adopt the euro as their own currency for quite some time. Full membership in the EMU is probably still a good decade away. But already, the euro is having profound impact on the region—pushing its countries toward the rigor that helped former economic laggards such as Spain and Italy.

*By Karen Lowry Miller
in Frankfurt*

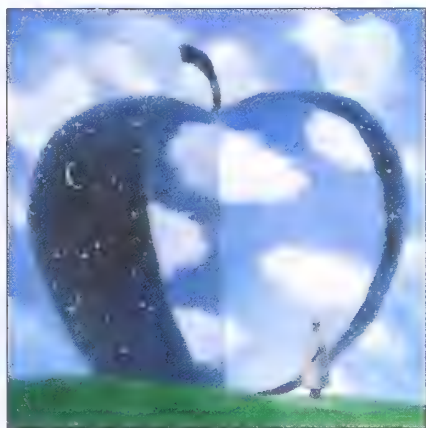
Is Central Europe EMU Material?

DEFICITS AREN'T DIRE... BUT INFLATION NEEDS TAMING



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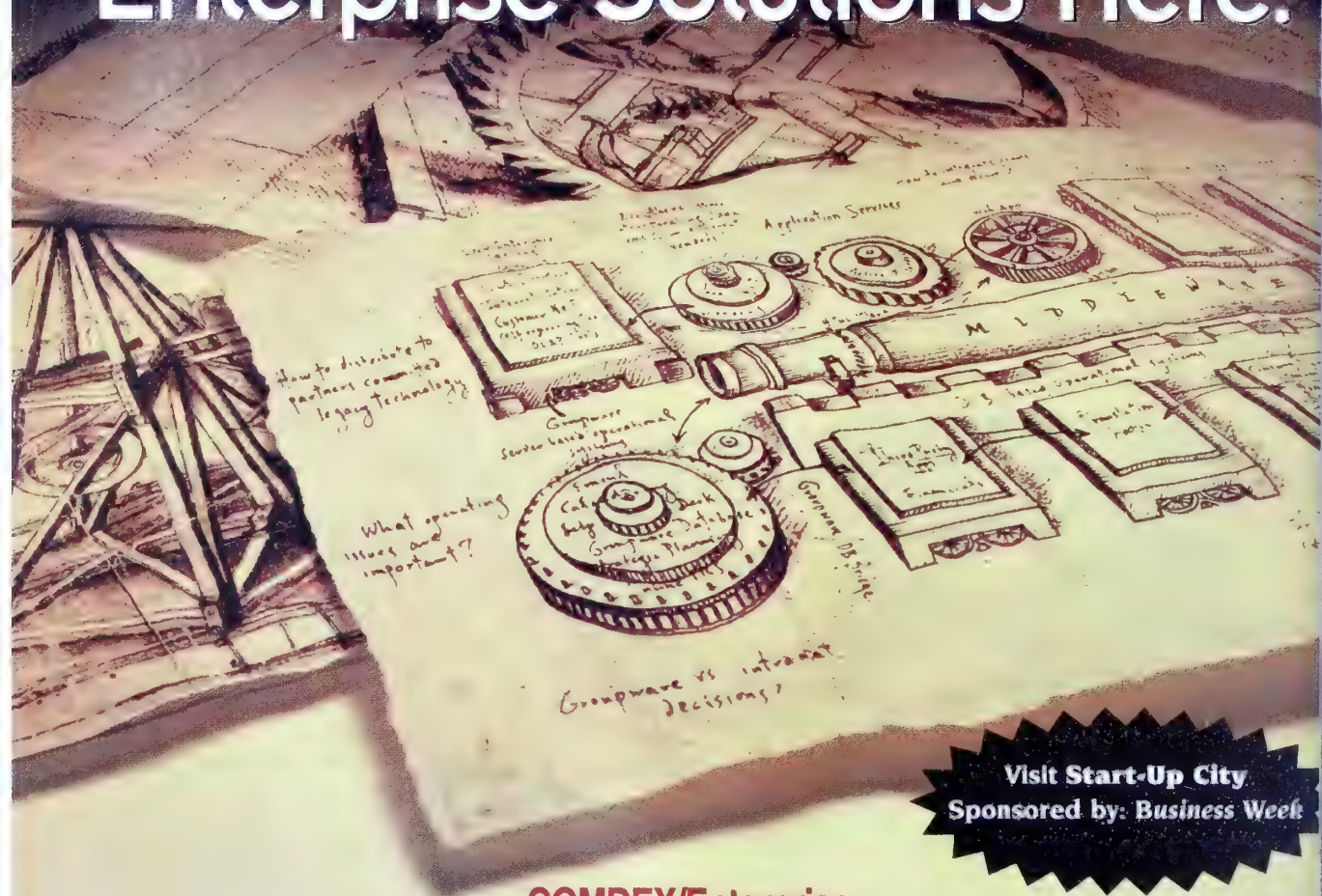
already committed more than 160 million dollars towards initiatives specifically designed to build access, not walls. One example is USQA: the national database we use to identify people who need access to special care. And to remind members to see their physicians for critical check-ups and screenings. We've also teamed with Johns

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EDITED BY JOHN TEMPLEMAN

S TOKYO READY TO TRUST THE COMMUNIST PARTY?

The Japan Communist Party might sound like a relic from the Cold War. But the 350,000-member party has softened its hard-line image and engineered a comeback by making play for millions of voters hurt by Japan's deepest postwar recession and disillusioned by the pro-big-business policies and haze of the ruling Liberal Democratic Party. "Many Japanese are starting to think that we're all they have," asserts party leader Kazuo Shii, head of the party's secretariat. "We're becoming socially acceptable and gaining credibility as a normal political party."

For the first time ever, the JCP is making overtures to other opposition parties such as the Democratic Party of Japan, with the aim of building a coalition capable of toppling the LDP from power. "We're ready to cooperate in creating a coalition government," says Shii, 44, a populist who has garnered support for the party. "We'll work together in the [Lower House], issue by issue, and then push to have the coalition dissolved [for an early election]."

A general election need not be held for two years, but a united opposition could force the LDP to call one early by gumming up the legislative process. Opponents have already lined up together to humiliate Prime Minister Ryuzo Obuchi. Though Obuchi had already been elected by the Lower House, which has the final say, the opposition—with JCP support—nominated DPJ leader Naoto Kan as premier in the Upper House.

GUARANTEEING OBUCHI. Now, opponents are mulling a strategy at risk of inflicting real damage. The LDP has 104 of the 252 seats in the Upper House, which can delay but not overturn laws passed by the Lower House. Potentially, a united opposition could stall action for up to 60 days on key legislation, such as a bank rescue plan, that Obuchi is desperate to enact. "This means more pressure for Obuchi," says former Prime Minister Yasuhiro Nakasone.

Many opposition politicians are still reticent about any formal ties with the Communists. "Can we work with a party that still regards the U.S. as an imperialist power?" asks Yukio Edano, a senior DPJ legislator. In mid-August, the JCP started to tackle that problem by offering to put some parts of its programs on ice, including a demand to scrap the U.S.-Japan security treaty.

At the same time, the LDP is looking temptingly beatable. It clings to power with a slim 14-seat majority in the 500-seat

Lower House. It is exposed both to possible desertions from within its own ranks and to unrelenting pressure for early elections. Even opponents leery of dissenting during a national crisis favor early elections—as do about half the electorate, according to an early August poll by the mass-circulation *Asahi Shimbun*. The same poll showed a massive 78% don't expect a better economy under Obuchi.

Since October, 1996, a series of wins has strengthened the JCP. In mid-July Upper House elections it garnered 14.6% of the national vote, making it the second-largest party there behind the DPJ. Its rise parallels the erosion of the LDP's support. Indeed, the Communists now lure votes from once solid LDP constituencies such as housewives, farmers, and even conventional salarymen. They

appeal strongly to voters fed up with the LDP's economic blunders. "I can't trust the LDP's policies looking at what's happened to the economy," says Toshio Nakai, manager of a small contractor near Tokyo, who voted JCP in July.

Voters like Nakai show how deep the LDP's problems now run. Provided present electoral trends continue, the ruling party is heading toward a rout at the next elections. If other opposition parties can overcome their suspicion of the JCP, Obuchi's reign might be short.

By Irene M. Kunii in Tokyo



SHII: Out to build a coalition

GLOBAL WRAPUP

KIM DOMINATES NORTH KOREA

North Korea's Supreme People's Assembly will convene on Sept. 5 for the first time in four years. It is set to reap communism's first dynastic succession by naming Kim Jong Il, elder son of "Great Leader" Kim Il Sung, as president and head of state.

Kim's rise marks the end of the long period he needed to consolidate power. In July elections, nearly two-thirds of Assembly delegates were replaced with Kim backers, mostly from the army. Now, say analysts, the way is

open for wider diplomacy by North Korea that desperately needs foreign aid to fight famine and break out of an eight-year depression.

JORDAN STOCK MARKETS SHINE

While most emerging markets have swooned in the wake of Asian and Russian economic meltdowns, Jordan's Amman Financial Market is doing just fine. On Aug. 25, it hit a new high, nearly 10% up from year-ago levels. Volume is up 42% so far this year, fueled by two large share issues by Arab Bank, which alone

accounts for some 45% of AFM's \$6 billion market capitalization. Business could get even brisker when the government implements promised privatizations such as that of Jordan Telecommunications.

Foreign participation in the market is low. Non-Arab foreign holdings are just 3.5%, though market sources say U.K.-based fund managers are taking several U.S. pension funds into the AFM for the medium term. "Our small size relative to other markets keeps us from some of their volatility," says Finance Minister Michel Marto.

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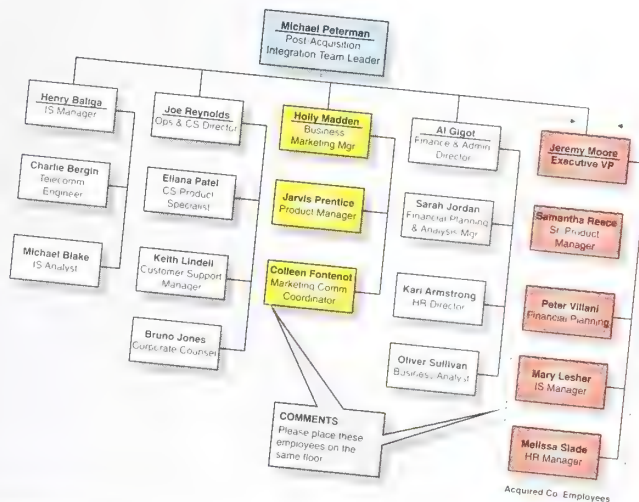
To: Chris Murphy, Facilities Manager
From: Mike Peterman, Post-Acquisition Team Leader
CC: Holly Madden: Jarvice Prentice; Colleen Fontenot, Jeremy Moore
Date: 07/27/98

Re: Acquisition Integration Plan

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Thanks,

MP



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IT WAS A HIT IN BUENOS AIRES —SO WHY NOT BOISE?

U.S. companies are picking up winning product tips from consumers in faraway places

In June of 1997, Häagen-Dazs began serving a new flavor called *dulce de leche* at its sole ice cream shop in Buenos Aires. Named after the caramelized milk that is one of the most popular flavors in Argentina, the locally developed line was an immediate hit. Within weeks, the super-sweet, butterscotch-like confection was the store's best-seller.

Just one year later, consumers from Boston to Los Angeles to Paris can find *dulce de leche* at the supermarket or in one of Häagen-Dazs's 700 retail stores.

In U.S. stores that carry it, only vanilla sells better. In Miami, *dulce* sells twice as fast as any other flavor. In the U.S., it does \$1 million a month in revenue. And in Europe, it will soon move up from a seasonal flavor to year-round status.

FERTILE FEEDBACK. The dessert is just the latest example of an emerging two-way trend among American marketers. No longer does the shrinking of the globe mean simply that U.S. companies pump out hamburgers, sneakers, and movies for the world to consume—or that Asian and European companies readily sell their goods in the U.S.

In globalization's latest twist, American companies from Levi Strauss & Co. to Nike Inc. are lifting products and ideas from their international operations and bringing them home. Although U.S. companies have long exported their products, a few have now begun using their international operations as incubators for the next big hit. "As the world becomes smaller—relentlessly, if slowly—the interchange and exchange of ideas is becoming much more commonplace," says Simon Williams, chairman of the Sterling Group, a New York-based brand consulting firm.

It's not just happenstance, either.



Americans are more
diverse—and more
open to new foods
and products

Companies are reorganizing so that ho products from one region of the worl can be more readily spotted and shipped elsewhere—either to the U.S. or other international markets. Reliance on the home office for product research, development, and ideas is shrinking. Within companies, says Jan Fraser, a consultant in McKinsey & Co.'s global practice, "the importance of the product is rising, and the importance of the country is beginning to decline."

Take Pillsbury Co., which owns Häagen-Dazs. After consolidating its international divisions last year, it now invites U.S. executives to training seminars to swap ideas. North American executives who had tried *dulce de leche* at a brand conference in January, 1997, realized it might fit with the company's recent move to target Latinos in the U.S. But the product did more than that. Today, U.S. sales of the flavor are growing by about 27% monthly—compared with 6% for another specialty flavor, coffee mocha chips.

"It's remarkable and unusual to have a new flavor do so well," says Vivian P. Godfrey, Häagen-Dazs vice-president for North America.

BUYING NON-AMERICAN. Quaker Oats Co., too, made strategic changes in its management to encourage the exchange of ideas across international borders. In March, the company cut a layer of management and merged some of the operations of its Latin American and Asian divisions. One goal of the changes: to build better communications between regions.

There are good reasons for the shift. An increasingly diverse U.S. customer base has companies searching for ways to connect with fast-growing ethnic groups. Rising levels of immigration also have brought salsa, soccer, and

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Thai food into the mainstream. At the same time, Americans of all backgrounds have become increasingly willing to choose more adventurous products. Altoids, a 200-year-old British product originally used to calm upset stomachs, now holds 17% of the \$281 million U.S. breath-mint category, having edged aside tamer candies such as Certs. "The popularity of stronger, more intense flavors has soared," says Liz Smith, general manager of Callard & Bowser-Suchard, a Kraft subsidiary that owns the Altoids mint. "What used to be daring and experimental is now broad-based and mainstream."

Moreover, the vast increase in imported products in the U.S. over the last two decades has made consumers and marketers far more comfortable with the idea of products with international roots than they once were. With U.S. households increasingly buying Japanese electronics and German cars, the "Not Invented Here" impulse no longer applies. "Most Americans who buy a Mercedes or Toyota don't think they're buying a value system along with a product," says Richard Pelles, a history professor at the University of Bonn who has written about the cultural effects of international trade.

To be fair, the trend is in its early stages. A good number of giant marketers, such as Coca-Cola Co. and RJR Nabisco Inc., say they have never taken a product or ad campaign from abroad and brought it into the U.S.

But others are happy to take the plunge. Nike has found success with shoes that don't appear to jibe with U.S. tastes. A soccer boot, designed with and worn by Brazilian national team member Ronaldo, was a hit at stores, especially during

this summer's playing of the World Cup. Two running shoes have also been imported to the U.S. A long-distance running shoe called the Air Rift, which

fits like a mitten with the big toe separate to better simulate running barefoot, was designed with the help of Kenyan runners. And the Air Streak was introduced first in Japan and a year later in the U.S.

The reason for the moves? Nike based them in part on an internal consumer study, which shows a decline in nativistic consumer sentiment in the U.S., especially among young buyers. That has inspired Nike to look abroad more often for new ideas. "All of our products used to be driven almost 100% by consumers

in the U.S.," says Juliet Moran, Nike's director of international marketing. "But we're now finding we're getting insights from around the world."

Other companies are hoping for similar outcomes. Levi Strauss, famous for exporting the all-American look of blue jeans to the world, is hoping to bring an offshore trend to U.S. consumers. For three years, a dark version of Levi's denim has been the hot seller in Japan. This year, Levi's is launching an offshoot called "hard jeans" that will be darker and stiffer than typical denim.

Levi's has told its U.S. managers that looking abroad for ideas is part of their job. "Three or four years ago, that would have been inconceivable in this

company," says Robert Holloway, Levi Strauss's vice-president for business development. "People had a much narrower view."

The tactic does not always work however. Sometimes, companies discover a product was successful abroad thanks to a dearth of competition. While Keebler Co. was owned by British-based United Biscuits PLC, it tried to import favorites from Rose's marmalade to Panda licorice to Kambo cooking oils into the U.S. in the early '90s. But Keebler was not able to make the pricey products distinct from established rivals, and the import languished.

That hasn't discouraged a host of new candidates already waiting at the border. Cereal partners General Mill

GLOBAL PRODUCTS HIT THE STATES



DULCE DE LECHE

Häagen-Dazs developed the caramel-flavored ice cream for Argentina. Now its popularity is second only to vanilla in U.S. stores where it's sold

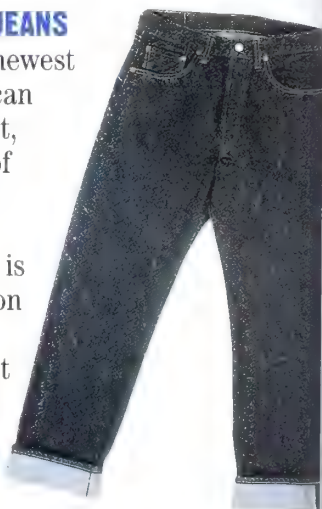


SOCCER BOYS

Nike says its Brazilian-designed boot is selling faster than expected in the U.S.

HARD JEANS

Levi's newest American product, made of darker, stiffer denim, is based on a hit product in Japan



Inc. and Nestlé have successfully invaded Canadian stores with a popular European chocolate breakfast. General Mills CEO Stephen W. Sanger says he thinks some products from the joint venture will eventually find their way to the U.S. And as new McDonald Corp. CEO Jack M. Greenberg figures out how to perk up his struggling U.S. division, he says he'll look for help from the company's international outlets. Already, he has reorganized McDonald's American management structure to resemble the decentralized setup overseas, and the company says ad campaigns and tie-ins may cross borders in the future.

Meanwhile, Häagen-Dazs isn't finished. If it can figure out how to import the ingredients, Godfrey says, it will soon sell its most popular Japanese flavor—green tea—in the U.S. Just imagine the possibilities for cross-cultural sundaes.

By David Leonhardt in Chicago

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ENTREPRENEURS

BROADCOM'S BRAIN TRUST



Engineers and Co-Chairs Samueli and Nicholas each own 23% of one of the year's hottest IPOs

Henry T. Nicholas III and Henry Samueli, co-founders of Broadcom Corp., the fast-growing maker of communications chips, have much more than just their first names in common. When Broadcom went public on Apr. 17, the two Henrys shared in the riches of one of the most successful initial public offerings this year: The stock's 123% jump the first day was second only to the all-time record 249% gain racked up by Broadcast.com in late July. So far, their combined stake—each holds 23%—has soared in value to \$1.5 billion.

Their newfound wealth is based on another fortunate similarity: co-chairmen Nicholas, 38, who is also CEO, and Samueli, 43, have long shared a common view of the future direction of communications technology. When they

founded Broadcom in 1991, they were convinced that quicker communications would drive the convergence of computers, television, and telephones. So they set out to develop the microchips that would tie together these disparate technologies and allow the speedy transfer of massive amounts of data. It was a prescient move. Now trading at around 70, Broadcom's share price has been pushed skyward by the proposed merger of AT&T and cable giant Tele-Communications Inc., which promises to accelerate the use of cable TV for phone and Internet service in the home.

EARLY TO MARKET. Even if that deal never happens, business is booming for Broadcom. Early on the scene with its chips, it already dominates fledgling markets for the electronic brains that control digital set-top boxes and cable modems. Altogether, analysts expect Broadcom to earn \$28 million this year on a 300% jump in sales, to \$150 million.

Samueli and Nicholas first met at TRW Inc. in 1981. Samueli designed communications systems; Nicholas designed chips. Both were working on a huge

Defense Dept. program to advance the state of the art for integrated circuits for communications applications. In 1985, as

Nicholas was earning his part-time masters degree at the University of California at Los Angeles, Samueli left to become a full-time professor there. With his research centered on furthering the automated design of communication chips, it was only natural that Nicholas became Samueli's first PhD candidate.

By 1988, when Samueli and three other scientists co-founded PairGain Technologies Inc. to speed data transmission over telephone lines, Nicholas went along to design the chips. But Samueli and Nicholas also had a broader vision. They wanted to figure out how to compress data so more of it could be sent over not only telephone lines but also over cables, corporate data networks, and even over the air and via satellite broadcasts. There was a problem, though. Doing so would mean competing with PairGain's customers. Still, they were

SHREWD MOVE: The pair used stock options to lure world-class scientists

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With 44 PhDs and 5 tenured professors, "if our markets head south," says Samueli, "we'll open a university"

certain of their idea that three years later, Samueli and Nicholas quit Pair-Gain—and walked away from millions of dollars in stock options—to start Broadcom.

For Samueli, founding Broadcom was the culmination of a boyhood dream. "I knew I was going to be an electrical engineer in seventh grade," he says. In an electric shop class at Hollywood's Bancroft Junior High School, he decided to build a shortwave radio with five tubes. "The rest of us were just learning to do splices, and here he was building this complicated radio," says Gregory B. Gershuni, a lifelong friend. "Building that radio put me on the path that got me where I am today," says Samueli. "I did not deviate, not one iota."

Nicholas also showed a scientific bent early on, though his career path was more circuitous. Growing up in Malibu, Calif., he dreamed of becoming a test pilot. "He had a mad-scientist lab in his garage to experiment with rocket fuel," says Andrew R. Coulson, a childhood friend who later roomed with Nicholas for six years during and after college. "We used to stay up all night mixing chemicals." Nicholas, Coulson, and another friend even taught themselves aerodynamics and calculus during junior high so they could design rockets that would shoot higher than off-the-shelf models. Although Nicholas made it into the U.S. Air Force Academy, his boyhood dream ended when he grew taller than its 6 ft., 4 in. limit for pilots.

"YIN AND YANG." These days, Nicholas and Samueli's success in piloting Broadcom is very much thanks to their particular chemistry. Employees describe Samueli as the inspirational leader, the thoughtful, humble, benevolent professor who lets you find the solution so you'll grow. Nicholas is the tough coach who yells at his players to hit new heights and is quick to assign blame when they don't reach them. Colleagues say the two function together so seamlessly, they routinely finish each other's sentences. "They're sort of the yin and yang of Broadcom," says Steve K. Tsu-

bota, who heads the company's cable-TV unit. "If you took either one out of the development of Broadcom, we wouldn't be a tenth as successful as we are."

Nicholas, who goes by "Nick," is clearly in charge of running the company, reversing the old professor-student mentoring relationship. "He's the CEO, and he likes being in charge," Samueli says. "We need Nick's style for working in the business world." It's Nicholas who insists on everyone wearing a suit and tie at all times. He talks a mile a minute, peppering his speech with wisecracks. And he's always pushing the limits, at work and at play. On skis, Nicholas will tackle any hill, and he has broken a collarbone to prove it. A bit of a boaster,

prefers to let someone else initiate conversations. "Some people can't handle the fact that he never talks," says his wife, Susan, an IBM programmer he met at a synagogue dance.

NO VENTURE CAPITAL. Samueli's reputation among fellow scientists has helped attract a formidable technical team. "He's very focused and he very quickly makes the right decisions all day, every day," says William J. Kaiser, chair of UCLA's electrical-engineering department. "I don't know anyone else like that in the business or academic communities. It also helped that the founders accepted no venture capital, so they could offer unusually large stock options as lure. "They compensated people with life-changing amounts of stock," says Tsubota. The proof is in the IPO. More than 70% of the company's then 300 employees became millionaires.

Often the enticements didn't end there. To lure world-class scientist Klaas Bult, then with Philips Electronics, Samueli arranged for Bult to talk with UCLA; the school offered him a tenured professorship, with Broadcom funding his research and an outside consulting contract. "Then, it was only a matter of time," Nicholas says. Two years later, Bult decamped for a full-time job at Broadcom. "That type of person is not looking for a job," Nicholas says. All told, 80% of the company's 239 engineers have advanced degrees, 44 with PhDs, and five of them are tenured professors. Quip Samueli: "If our markets head south, we'll open a university."

That isn't likely to happen anytime soon. True, several years ago, the big push for convergence got off to a false start amid much hype and confusion

But the AT&T-TCI deal makes it look as if it will really happen this time. To keep the Broadcom rocket on its trajectory, Nicholas and Samueli expect to solidify links to such fast-growing network customers as 3Com, Cisco Systems, and Bay Networks even as they secure the leadership in the nascent market for cable gear. So far, at least, the two Henrys seem to have all the right stuff.

By Larry Armstrong in Irvine, Cal

BROADCOM'S MAD SCIENTISTS

Henry Samueli

Henry Nicholas

BORN

1954 in Buffalo, N.Y.

1959 in Cincinnati, Ohio

EDUCATION

B.S., 1975, PhD, 1980, in electrical engineering from UCLA

B.S., 1981, PhD, 1997, in electrical engineering from UCLA

AS A KID, DREAMED ABOUT BECOMING...

An electrical engineer

A test pilot

PET PEEVE

"I'm a quasi-neat freak; things should be in their proper places"

"I hate people who think something's not possible"

ATTITUDE TOWARD WORK

"Never do anything halfway or less than the highest quality"

"Work should be hard and painful; the fun is winning"

FAMILY

Married, three daughters

Married, two sons and a daughter

INTERESTS

Skiing, hiking, basketball

Bungee jumping, sky diving, lifting weights

he claims that when his wife, Stacey, had their third child, "I delivered it myself." Says Stacey, a former chip designer who worked for him at TRW: "Well, it was really the nurses and Nick."

Samueli, who took a leave of absence from UCLA to serve as Broadcom's chief technical officer, is quiet and understated. A better skier than Nicholas, Samueli will never brag after effortlessly gliding down a double-diamond slope. He

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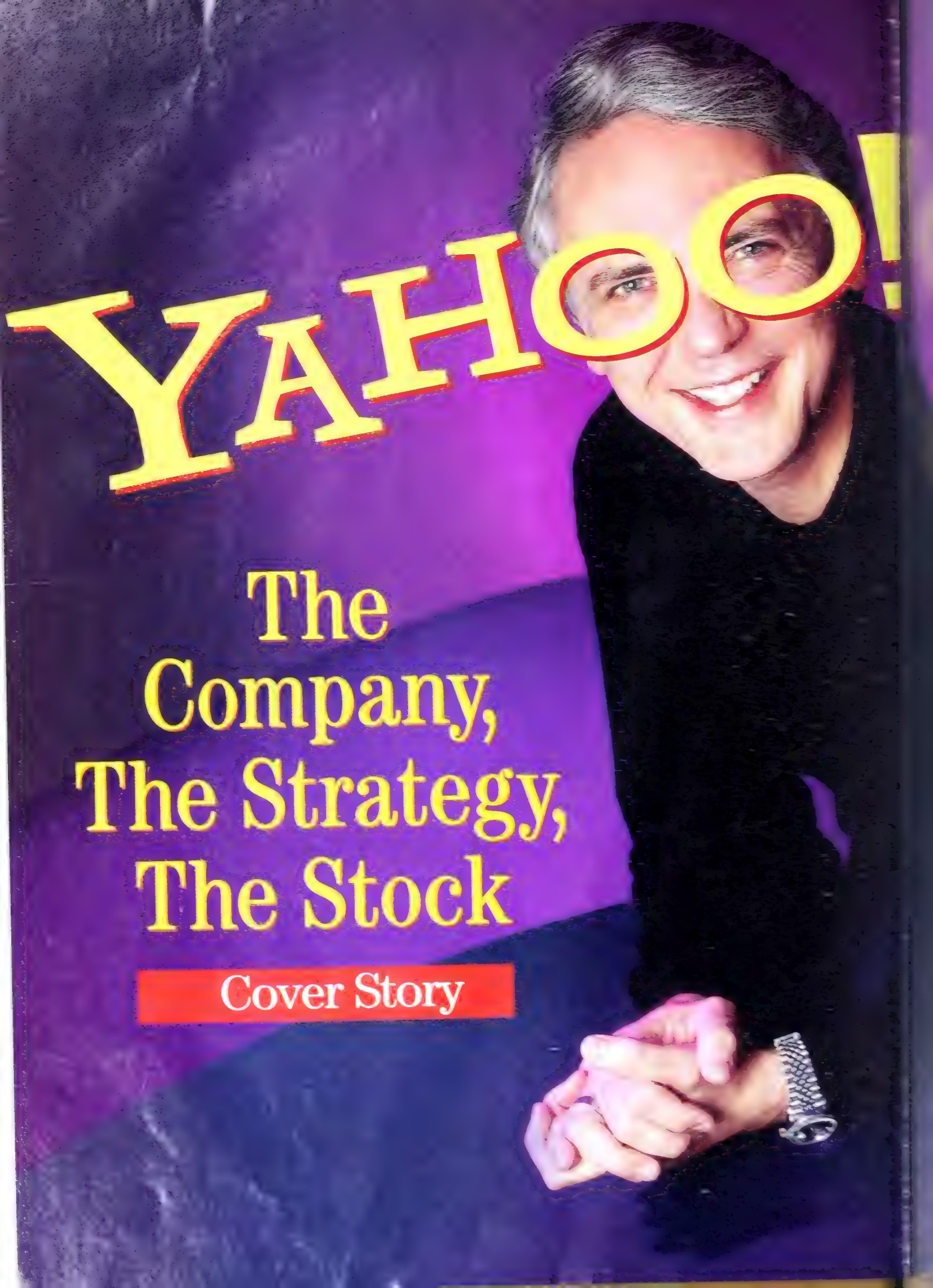
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Cover Story

Today, it's the lord of the Web. But powerful rivals are moving in fast. Can Yahoo! keep clicking?

On July 17, the top dogs at Warner Bros. Online gathered around a giant TV screen in their offices high above the streets of Los Angeles. But instead of watching Bugs Bunny, Daffy Duck, or some other famous Warner cartoon, they found themselves transfixed by an internal slide presentation of a giant yellow Pac Man. His name: Yahoo! His target: nearly everything.

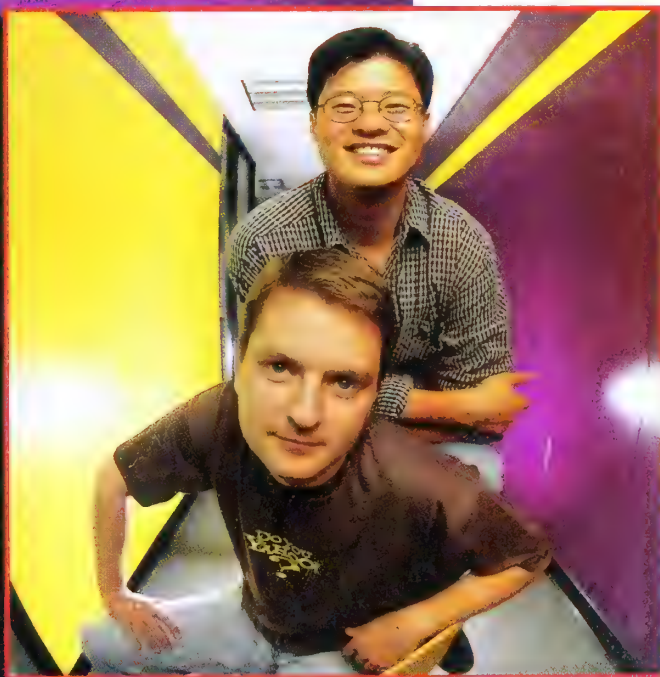
The mesmerized executives watched as Yahoo ate his way through the best that the Internet has to offer. First, he gobbled up the rights to news from such titans as CNN and Reuters Holdings PLC. Then he moved on to electronic commerce, downing deals with retailers such as bookseller Amazon.com Inc. and music outfit CDnow Inc. The voracious little creature went on to munch his way through Internet staples E-mail and chat rooms before finally coming to a stop just before entertainment. "Yahoo just gets bigger and fatter and gets more and more revenue," said James Moloshok, senior vice-president at Warner Bros. Online. But no more, he told his troops: Warner would fight back.

How did little upstart Yahoo! Inc. make it onto the radar screen of Warner Bros., a division of media goliath Time Warner Inc.? In just three years, Yahoo has morphed from an ordinary search service into the be-all, do-all of the Net, offering a dizzying array of services and information. Need a daily fix of news, stock quotes, weather, and E-mail? Head to Yahoo. Want to house-hunt, figure out a retirement plan, or research the Ebola virus? Yep—Yahoo. It's even a Web hangout for those craving a little R&R of, say, online blackjack, shopping for premium handmade cigars, or Koi pond supplies.

HEAVENWARD. Vast selection has catapulted Yahoo into the No. 1 spot on the Web, with 40 million people who log on every month—more than the 30 million who tune in weekly to NBC's top-rated TV show, *ER*. And Yahoo's stock? It has soared heavenward, to 23 times its 1996 IPO price: The market capitalization was \$9.1 billion on Aug. 25. That day the \$97.50 stock price

was 305 times projected 1998 earnings of 32¢ a share—astounding, considering that Microsoft Corp., the computer industry pacesetter, is valued at 52 times earnings. Yahoo CEO Timothy Koogle is unfazed by the valuation: "I'd be hard-pressed to say it's overhyped. We've set out to make Yahoo the only place anyone needs to go to get connected to anything. There's nothing in the real world to compare to that."

Little wonder, then, that media companies such as Warner Bros. and Walt Disney Co. are in such a stew over what to do about the Silicon Valley company. At stake is not only how to get the attention of today's 90 million cybersurfers. It's a digital land rush, with companies madly scrambling to stake a



HIGHFLIERS

A few years ago, Yang (top) and Filo were Web-surfing grad students. Now, they and CEO Koogle (left) are cybergomuls

Media behemoths are piling into the portals business li

claim as an information giant in the next century. Already, more people are hopscooting across Web sites than the number of viewers TV could claim after a dozen years in existence. And there are no signs the Web's growth is slowing: By 2002, some 328 million people around the globe will be using this far-flung information pipeline, according to International Data Corp.

What's emerging faster than many imagined is a Net generation that rises not to its newspapers and TV news shows but to its coffee and glowing

Cover Story

computer screens. Some 64% of cybersurfers watch less TV now than they did before their Web-cruising days, while 48% are not reading as much, according to market researchers Strategis Group. Suddenly, the prospect of being a media goliath without grabbing the eyes, minds, and pocketbooks of the Internet droves seems dicey indeed. "With Yahoo, you can't measure things like price to sales," says Abel Garcia, senior vice-president at investment firm Waddell & Reed Inc., one of Yahoo's largest shareholders. "You have to look at it as the new media company of the 21st century."

And that could be a mouth-watering prospect. Unlike traditional media, this new Internet breed will dish up not only information and entertainment but also a way to act on it.

Like New Age general stores, new media companies stock news, staples, and all the hottest gossip. Consumers, for example, can get the latest information on long-term mortgage rates—and find a real estate broker, view their dream home and apply for a home loan, all under one roof. When a deal is struck, the new media company collects a fee.

GLITZED-UP GATES. This lucrative, one-stop Web site approach is the most coveted business on the Net today. And oddly enough, it goes by the drab name of "portals." These are the glitzed-up entrances to the Web that have so many goodies that their operators hope cybersurfers congregate en masse and then rarely venture elsewhere. And like all high-rent districts, they can charge a premium for advertising while also cashing in on consumer E-commerce. Online shopping alone is expected to balloon to \$37.5 billion by 2002, says Jupiter Communications.

This has not escaped the giants of the media world, who are piling into the business like so many giddy teenagers squeezing into a Volkswagen Bug. In July, NBC spent \$6 million for a 19% position in Snap!, the struggling portal operated by CNET Inc. Disney quickly ponied up \$70 million and traded its majority stake in Starwave Corp. for 43% of rival Infoseek Corp. And insiders say that Excite Inc. has held talks with several media giants, including Time Warner. "The pitter patter of competitive footsteps has turned into a clip-clop,

The Be-All and Do-All of the Net

Forget directories. Yahoo! is a full-blown package of information and services. Here's how a sampling of services on Yahoo! stacks up against rivals, with "rad" as the highest rating, followed by "cool," then "so what," and finally "lame."



FINANCE

A superdeep set of offerings, including quotes, graphs, analysts' ratings, and company information—all easy to find. The breadth of news from Reuters, S&P, and AP sets it apart, although Microsoft's Investor and Excite also are first-rate. Yahoo! Finance isn't for high-roller investors but is great for little guys.

RAD



REAL ESTATE

A wide variety of tightly integrated information from real estate's RE/Max and online loan service E-Loan, as well as national classifieds on home sales and rentals. Although Excite offers easier-to-use graphics and Microsoft's HomeAdvisor is flashy, Yahoo! has nifty information on crime rates and quality of life.

COOL



HEALTH

To put it nicely, Yahoo! has a lot of work to do. The service provides health news from Reuters and medical site listings, but Excite, Infoseek, and Lycos do a better job by offering news features, tips, and quizzes from iVillage and HomeArts. For great sites, check out Thrive, IntelliHealth, and Mayo Health.

LAME



SEARCH

Yahoo! pioneered the field, using categories a way to help guide you through searches. Now Excite and Lycos help people wade through cobwebs better. Their solution? Asking whether the results are hot or cold, and then looking up data that are closer to the target. Excite also suggests first and last names to narrow searches.

COOL

Managers into a VW bug

's Internet analyst Mary G. Meeker of Morgan Stanley Dean Witter.

Almost overnight, the competition has gone from stiff to downright scary. Existing portals such as Infoseek have been beefed up with cash from media companies, while TV networks have realized that they have no intention of being networked by a cyberspace upstart. Technology bigwigs Microsoft and Netscape Communications Corp. are joining the scramble, too, joining the powerful draw of their browsers to them. From America Online Inc. to General Electric Co./NBC, these giants are poised for combat. Enemy No. 1: Yahoo. "This is the first time since Yahoo started that it will be vulnerable," says Halsey M. Minor, CEO of rival CNET. "In the next few months, things will be vastly different."

BILLBOARDS? The firepower of new and invigorated rivals worry enough for Yahoo. But the company may be facing a more fundamental threat: convincing Corporate America that it can get a big bang for its buck by advertising online. A small but growing number of companies are beginning to question the value portals bring to their marketing efforts, which could take the air out of worldwide ad spending forecast by Forrester Research Inc. to hit \$15 billion by 2003.

Charles Schwab & Co., for example, no longer pays millions to AOL to be featured on its finance channel because it says less than 5% of its customers used AOL to get to Schwab's Web site. "Customers were looking at positions on portals as if they were like billboards on the side of the road," says Martha Levy, Schwab's senior vice-president for electronic brokerage. Over time, they just become part of the landscape." Could it be? Is highflier Yahoo a mouse-click away from being a has-been? Already, analysts are predicting that no



more than a handful of the more than a dozen already-declared players will survive the portal melee. They warn that the added competition—along with the ever-mushrooming number of Web sites—could spread crucial advertising revenues too thin. This year, portals are expected to attract 15% of Web traffic and 67% of North American ad dollars, or \$870 million. By 2003, though, they will grab 20% of traffic but only 30% of ad dollars, or \$3.2 billion, according to Forrester. "It's a real threat to Yahoo," says Forrester analyst Chris G. Charron.

Most experts are placing bets on AOL, with its 12.5 million subscribers—who account for 36% of the Web traffic that comes from households. And Microsoft gets a thumbs-up because, well, it's Microsoft. Although the software giant's online service Microsoft Network has been a huge disappointment, its new portal, MSN.COM, launched for the most part in late August, is expected to hit the mark with Netizens (page 76).

But it's tiny 600-person Yahoo that gets the most nods. It was first to market with a detailed search service, first to go



the place for news. The vast selection of sources—from AP to the Wall Street Journal—is immense. Also offers a variety of topics, from technology to human interest. Still, it can be overwhelming—with news, short takes, and in-depth stories galore. Snap! If you don't give up a second, though.

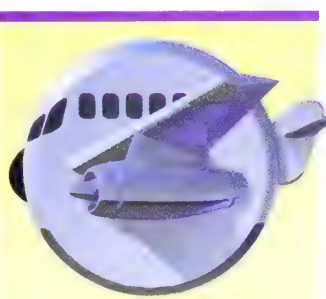
ROAD



PERSONALIZATION

My Yahoo! is extensive. It lets you pick your favorite topics—from stocks to weather—by creating a site customized to your tastes. True, Excite goes one better by having your preferences travel with you throughout that site. My Yahoo!, though, is really worth using if you plan to spend much time on the site.

COOL



TRAVEL

This smart setup offers hotel, car, and flight reservations. But the bookings automatically link to travel service Sabre, without giving alternatives such as bargain-finder Priceline. Infoseek and Lycos first link to Microsoft's Expedia and Preview Travel and connect to other sites.

SO WHAT



SHOPPING

If you thought shopping malls were dead on the Web, think again. Yahoo! has one, and it's doing its darnedest to lock you into its choice of stores, including Gap and CDnow. Snap! has easy-to-use listings and search to help sort through a wider selection. Yahoo! is still helping, offering an electronic shopping assistant.

COOL



Sky-high: Since 1996, Yahoo! stock has climbed to 23 times its IPO price

public, first to turn an annual profit, and first to go mainstream by slapping its zany name on TV.

Now, Yahoo is promising to go where no portal has gone before—to telephones, televisions, pagers, handheld organizers, and the like. Koogle and his troops are working feverishly so that by early next year, Yahoo's zippy Web pages are accessible anywhere and from any device.

Even sooner, perhaps by yearend, the company plans to give its registered users the velvet-glove treatment by offering a so-called Yahoo wallet. This would allow users to register their credit cards and shipping addresses with Yahoo. Then, when they shop anywhere on the Web, they can take

their virtual Yahoo wallet with them to make purchases instantly. As with credit

cards, Yahoo will keep a tab and present a monthly online bill. "We want to build the biggest company we can," vows the 47-year-old Koogle. "We've taken the lid off."

The method in Yahoo's tactics is nothing short of madness. Indeed, the company's motto demands it: Do what's crazy, but not stupid. Nowhere has this principle been stronger than in Yahoo's branding campaigns. By conjuring up a cool California image—hip but not rad, easy-to-use but not simplistic—it has managed to create a cultlike following not unlike that of Apple Computer Inc.'s Macintosh.

CASHING IN ON CACHET. Today, the Yahoo name is scrawled on seemingly every available surface. At the hockey rink of the San Jose Sharks, it's on the Zamboni ice-shaving machine. It's wrapped around tins of breath mints. It's on Slinkys, parachutes, skateboards, sailboats, surfboards, yo-yos, and kazoos. And the purple and yellow letters will soon appear on shoes, a music CD, the *ER* show, and the upcoming Ron Howard movie *Ed TV*. The best part: Yahoo has paid barely a whisper for all this publicity. In its early days, the company bartered for placement, but now—since gaining cachet—it gets much of this gratis.

Truth be told, the Yahoo brand may be the company's biggest asset. While rivals such as Excite or Infoseek may match Yahoo's information, services, and shopping, few have come close to its branding. Some 44% of Internet users know Yahoo, according to Intelliquest Inc.—more than are familiar with Excite, Lycos, or even Microsoft (table, page 72). Only AOL and Netscape are better known. "The name contains the promise of the product," says Owen Shapiro, senior

analyst at market and brand research firm Leo J. Shapiro & Associates. "It reinforces the idea that when I go to Yahoo I'll be so pleased I'll be Yahooing afterwards."

Although the company has helped define Internet branding, it must now keep redefining it to stay ahead of deep-pocketed rivals such as NBC. Yahoo was the first Net upstart to hit the airwaves with a series of humorous TV commercials in 1996 (*Do you Yahoo!?* remains a company tagline). But TV ad alone just won't cut it anymore. Now, Yahoo is trying to go one step further with product placements on TV's *Ally McBeal* and *Caroline in the City*. And in an Aug. 27 announcement, Yahoo linked its brand with the likes of the Oakland Athletics baseball team and the popular Comedy Central cable channel by forming online clubs for their fans.

HUE AND CRY. In a stab to get beyond T-shirts, of which it already has 20 different varieties, it licensed the logo to Gregory Mountain Sports, which is making computer bags to be sold in Staples Inc. and REI stores this fall. "We want a name that will stand the test of time," says Karen Edwards, vice-president for brand marketing, who joined Yahoo in January, 1996, after having done battle in the trenches at computer maker Apple's ad agency BBDO Worldwide Inc. Edwards is so gung ho that she planted her Palo Alto (Calif.) garden this summer with purple petunias and yellow gladioli—the company's colors.

No doubt Yahoo's power brand will be one of its greatest weapons in fending off the coming assault. So, too, will be its healthy bank account. The company is sitting on almost \$400 million in cash, thanks in part to a \$250 million investment on July 8 by Softbank Corp., which now owns 31% of Yahoo. This is part of Softbank's strategy of Internet investments, including stakes in E*Trade and GeoCities. The Softbank money, not to mention Yahoo's stock, will come in handy as Koogle pursues a more aggressive acquisition strategy than in the past. Yahoo has made only four acquisitions so far, including the \$49 million stock purchase of ViaWeb. But with greater competition and a need to keep expanding its service, Koogle says more are in the offing.

Apart from cold, hard cash, Yahoo has its stock price going for it—so long as it stays aloft. Compared with tech darling Microsoft, with a share price 2.7 times its projected 1999 earnings growth rate, Yahoo seems pricey at 4.1 times

expected earnings growth. For Yahoo to be valued the same as Microsoft, it would have to hike earnings 66% next year—well above the 45% increase analysts are forecasting. Nonetheless, 14 out of 20 analysts rate the stock a buy. Why? Most say they expect the company will remain a leader in portals, casting in handsomely in coming years. A big help: Yahoo boasts gross margins of 88%, just shy of Microsoft's 92%. "Yahoo has the potential to emerge as the first pure Internet

Cover Story

Yahoo! by the Numbers

YAHOO!'S EARNINGS

1998	32¢*
1999	46¢

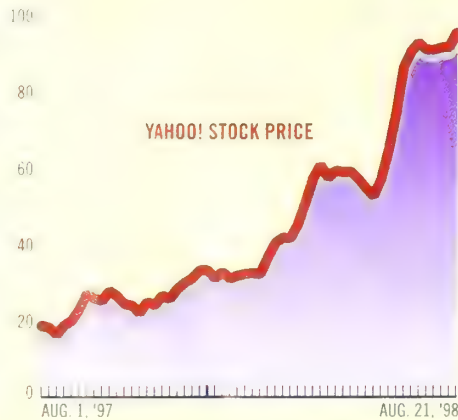
ESTIMATED ANNUAL P-E

YAHOO!	305
AMERICA ONLINE	111
MICROSOFT	52

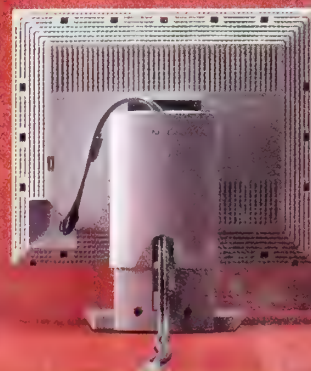
ANALYSTS' RATINGS

BUY	14
HOLD	5
SELL	1

* Without an acquisition-related charge



DATA: FIRST CALL CORP., BLOOMBERG FINANCIAL MARKETS



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up to 170° viewing angle
10° up, down, left and right

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universal mounting on a wall, stand or

arm. Optional MicroTouch™ touch screen

capability and OptiShield™

protective glass.*

Model	Viewable Size	Resolution	Weight	Power (Max)	Response Time	Price (Est.)
MultiSync LCD2010™	20.1"	1280x1024	22.2 lbs (10.1 kg)	9W	16ms	\$99
MultiSync LCD1810™	18"	1280x1024	17.2 lbs (7.8 kg)	9W	16ms	\$99
MultiSync LCD1510™	15"	1024x768	11.2 lbs (5.1 kg)	9W	16ms	\$99
MultiSync LCD1310™	13"	1024x768	7.2 lbs (3.3 kg)	9W	16ms	\$99

*Optional MicroTouch™ touch screen available for \$149.95. Price includes power supply and mounting hardware. Price excludes tax, shipping and handling.

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NOT TOO HIP: Koogle (at the wheel) is a foil for Filo and Yang's zaniness

Technically, Yahoo! is "Yet Another Hierarchical Officious Oracle"

giant," says analyst Paul Noglows of Hambrecht & Quist Inc.

But first, it will have to maintain its knack for giving Netizens what they want. That's

why its executives have been in nonstop meetings (in sparsely furnished conference rooms bearing names such as Decent or Consistent—just so that people will be forced to say they are "in Decent" or "in Consistent") to discuss the company's tenuous future. "We are in the business of obsoleting Yahoo," says 29-year-old co-founder Jerry Yang, whose success has made him so popular in his parents' home country of Taiwan that he registers in hotels under an assumed name to avoid a crush of autograph-seekers.

Cover Story

It wasn't always that way. When Yang and David Filo were Stanford University graduate engineering students in late 1993, they were about as far away from Big Business as twentysomethings could be. Instead of writing dissertations, they spent most of their time surfing the Web and building lists of their favorite sites. On a whim, they decided to post their list, dubbed "Jerry's Guide to the World Wide Web." The reaction was explosive. So in 1995, the dissertations were chucked—and so was the list's name. Instead, Yahoo, which technically stands for Yet Another Hierarchical Officious Oracle, was born.

In the future, playing up this friendly neighborhood feel of Yahoo and downplaying its commercialization will be key to getting surfers to stick around. According to Media Metrix Inc., users hang out at Yahoo's site an average of nine minutes daily, vs. about 42 for rival AOL's proprietary service. Ya-

hoo is trying to increase that through its Hollywoodesque programming. On July 21, for instance, more than 18,000 people asked more than 100,000 questions during an online discussion with teen heartthrobs Hanson. And during the recent World Cup, Yahoo's multilingual site drew an estimated 13.5 million people—4 million from outside the U.S.

But with Netscape, Disney, and others on its heels, Yahoo will have to do more. Such as get personal. While all the major portals offer personalized services, Yahoo leads the pack with 18 million consumers registered on My Yahoo, a feature that stores personal data, such as ZIP codes and the occupations of people who choose to use it. That information, which is kept confidential, allows Yahoo to tailor advertisements merchant's wares, and other services to consumers who would be most interested in them.

USER-INTIMATE. Yahoo plans to capitalize on knowing people's tastes by using push technology to tailor information and deliver Web material to the desktop. "I can picture Yahoo as a big depository for people's preferences and consumption patterns," explains Koogle, who is known as "T.K." around the office (page 74). "We'll have the ability to notify people of things they should tune into."

Or buy. At the moment, when it comes to E-commerce, the job of a portal is to send as much traffic to its partners' and advertisers' home pages as possible. But Yahoo hopes to do even more, including suggesting items for purchase based on an individual's preferences and past buying behavior. It also wants to launch an online billing and buying service. Yahoo already has a relationship with Visa International and is talking with Intuit Inc. and others about the venture. "We can be a central buying service," explains Chief Operating Officer Jeffrey Mallett, 34.

That's a shrewd move for Yahoo, which, like other portals, expects E-commerce to contribute a bigger piece of its revenue pie. Currently, E-commerce is expected to bring in some \$42 million, or about 25% of Yahoo's projected 1998 revenue of

Name That Internet Brand

Portion of the population that recognized these companies



	INTERNET USERS	NON-INTERNET USERS
AMERICA ONLINE	60%	17%
NETSCAPE	45	3
YAHOO!	44	2
MICROSOFT	43	12
EXCITE	11	0
ALTA VISTA	10	0
INFOSEEK	8	0
LYCOS	7	0

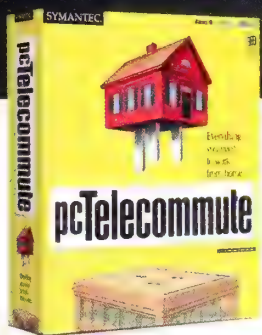
DATA: INTELLIQUEST FIRST-QUARTER
WORLDWIDE INTERNET TRACKING SERVICES STUDY

SHOWING HER COLORS

Marketing chief Edwards is pushing the brand hard. She says: "We want a name that will stand the test of time"



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Way beyond T-shirt

reach some 400 million viewers in the summer and double that in the fourth quarter. "We think we can create a success with Snap! by bringing it to the attention of a much larger audience," says NBC President and CEO Robert C. Wright.

The Disney-Infoseek combo also is about to turbocharge its promotion efforts. In addition to TV, Disney will use its movies, theme parks and cruise ships to raise Infoseek's profile. But may not be known as Infoseek for long. By the end of the year, the alliance will unveil a new portal that will serve as an umbrella for Disney's roughly 25 Web properties. For its part, Excite is hot on Yahoo's trail, with a host of new ser-

vices and promotional ventures of its own. Ditto for Netscape. Says Michael J. Homer, executive vice-president at Netscape portal Netcenter: "It takes exactly one click for someone to never be a Yahoo user again."

Even before Yahoo feels the competitive heat, its fate depends largely on advertising. Today, the Internet is still an unruly frontier many are unwilling to bet on. The sugar daddy of all advertisers, Procter & Gamble Co., for instance, spends just \$10 million on Net ads annually, out of its \$3 billion a budget. Executives from several major companies said at an Aug. 20 online ad conference that their puny Web spend-

\$170 million. The rest comes from advertising. But Google expects that E-commerce will climb sharply within a year. Yahoo's popular finance site, for instance, where Media Metrix says 1.5 million users each month spend roughly 24 minutes of their time, may alone be worth \$100 million in revenues from ads and other commerce within a year, say analysts.

And then there's expansion overseas. Yahoo is currently operating in nine different languages in 14 countries, including Australia, China, and Germany. Yahoo Japan is the most popular Web site in that country, where 10 million people are online. Overall, Yahoo estimates that 30% of its traffic comes from outside North America.

Will all this be enough? It's too early to tell—at least until Disney, Microsoft, and others play their hands. Rival Lycos, for one, nearly matches Yahoo's international record. It is in 11 countries in Europe alone. And archrival AOL shows no signs of slowing. It boasts a boatload of subscribers to its proprietary service and has plans to launch a new Web portal this month based on its recently acquired ICQ instant messaging service. ICQ (short for "I seek you") has nearly 7.5 million active users. Its wild popularity stems from its focus on a mix of E-mail and chat called instant messaging. The move is expected to appeal to hip young Netizens and to fill a void left by AOL's less-than-stellar Web site, AOL.com.

TURBOCHARGED ADS. The Dulles (Va.) company raked in \$2.6 billion in revenues in 1998, 15 times Yahoo's expected revenues. Given that, AOL executives say that not even high-flying Yahoo will be able to threaten AOL's bright future. "Everyone is changing to be more like AOL," says President and Chief Operating Officer Robert W. Pittman. "But no one is going to out-AOL AOL." CEO Stephen M. Case takes a more measured approach: "We just need to make sure we're innovating rapidly. That's really the way to fend off any competitive threats."

That's what NBC thinks, too. But first, its focus will be on branding—an area that Yahoo has largely dominated. On July 27, NBC began airing a quirky ad campaign aimed at making Snap! a household name. NBC says the ads, with the tag line "Don't suffer from information overload. Snap! Out of It," should

MEET THE GROWN-UP VOICE OF REASON AT YAHOO!

Timothy Andrew Koogle hardly seems the Silicon Valley bigwig that he has become. As CEO of Internet highflier Yahoo! Inc., Koogle shuns geeky Net-speak. Instead, he talks in T. K.-isms—folksy phrases that draw on his Southern roots. "Mamby-pamby," for instance, is Koogle's term for ideas that lack substance. "Possum syndrome" means indecision—when employees see headlights coming toward them and freeze. Then there's the "rowboat syndrome," which describes people who spend too much time looking backward instead of forward.

No one would accuse Koogle of suffering from that. Since taking the wheel at Yahoo in August, 1995, the 47-year-old executive has been in overdrive. His business savvy, drawn from three engineering degrees and 15 years in high-tech management, has been critical to the success of this company, where the average age is 29. Indeed, Koogle is the voice of reason in an environment brimming with breathless Net enthusiasts. "He's very decisive and very focused," says board member Michael Moritz, who interviewed a half-dozen candidates for the top job before settling on Koogle.

That's not to say Koogle can't yuck it up. But ever the businessman, he par-

takes in few of the zaniest antics. For example, before the company went public in 1996, founders Jerry Yang and David Filo took on the titles of Chief Yahoos. But Koogle steadfastly refuses to become the Chief Chief. He hasn't tattooed the company logo on his rear end, either, as has another executive. And he declined a request for this publication to spray-paint his graying mane in Yahoo's trademark blue and yellow colors.

LIVELY DEBATE. As Yahoo's sixth employee, the lanky Koogle made his mark early. The company's co-founders from Stanford University and caught in the freewheeling culture of the time were reluctant to turn their site into an advertising-driven enterprise. But pragmatic Koogle persuaded them they could make money and still serve their online treats gratis.

He turned them around not by imposing his knowhow down their young throats but by building consensus through lively—sometimes painful—debate. Even today, Koogle leads the founders, along with Chief Operating Officer Jeffrey Mallett, through the most pressing issues as a team. He plays the enthusiastic, big-picture Filo, the reserved technology wiz.

Yahoo! logo is turning up even on sailboats

wouldn't go up much until electronic ads become more consumer-friendly and interactive and until their effectiveness can be better measured.

Even an Internet startup is not convinced. Chris Larsen, CEO of Palo Alto's E-Loan Inc., an online mortgage business, says his company does better relying on traditional media for promotion than on the portals. In July, E-Loan spent \$250,000 on radio ads in California and Washington. The cost per customer: about \$200, with about a 2% conversion rate on resulting loan applications. By contrast, Larsen's on-line deals cost him at least \$300 a customer, with a conversion rate of just 0.5%. "Long-term, we think traditional media is the way to develop the brand," says Larsen. "I don't want to be too dependent on portals."

And as consumers get more Net-savvy, they may not need helping portal hand. Jerry Kaplan, CEO of Internet auction

house ONSALE Inc., says his company has seen its traffic from portals shrink rather than a cheap T-shirt in the past year. He figures the drop stems from increased awareness of E-Loan's brand. "The next time I see the crank in Inter-

net, the all-business operation; and Koogle, the veteran. "It's pretty unusual when managers do so well," says Eric Schmidt, a board member and computer trade publisher.

Most seems that Koogle intended to take the reins of the flying startup. Since 1977, an entrepreneur has carried him from obscurity. His father, a mechanical machinist, taught him to build engines, a skill he used while growing up in Alexandria, Va. Later, he put himself through Stanford by rebuilding the engines of student cars and founding a company that did industrial repair for companies in the area.

Koogle took his education and worked for mechanics to

Inc. in 1983, where for nine years he worked in its operations and capital groups. There, while deciding whether to plunge millions of dollars into promising—or not so promising—business plans, he learned the art of risk-taking. After that, he joined Seattle's Intermec as president, increasing sales at the data-communications product maker by almost 100% in his three years.

net commerce will be that certain sites will emerge as destinations on their own, thereby eliminating the necessity to buy a broad presence on the portal sites," he says.

Koogle concedes that some businesses, particularly those with the best-known names, won't need to rely on Yahoo and other portals to attract online customers or build brand awareness. But he says most merchants will flock to them for their services, strong distribution, and loyal following. Media Metrix says 51% of Net surfers at work and 42% of those at home use Yahoo at least occasionally. That powerful presence is expected to keep the ad dollars rolling in. Forrester figures Yahoo will nab at least a quarter of all portal ad money in 2002.

That's why E*Trade Group Inc. CEO Christos M. Cotsakos, whose Internet brokerage put up millions of dollars on Aug. 6 for ads and access to Yahoo's finance channel customers, says that banking on Yahoo is a no-brainer. "It's like playing Double Jeopardy," says Cotsakos. "You place your

Cover Story

Timothy Andrew Koogle



NICKNAME "T. K."

BORN July 5, 1951, in Alexandria, Va.

EDUCATION BA, 1973, from the University of Virginia—graduating first in his class. Awarded a full scholarship to Stanford, where he earned an MS in 1975 and a PhD in engineering in 1977.

FAMILY Divorced with no children. Parents dead. One older brother, Grayson.

PETS One cat named Morley (not after Safer).

HOUSES One in Seattle, across the lake from Bill Gates. Koogle bought it while working there for Intermec, a maker of data-communications gear. Another in Saratoga, Calif.

HOBBIES Collecting vintage guitars (mostly electric), including a 1972 Stratocaster, a Beatles Rickenbacker, and an acoustic D-41 Martin. He plays them, natch. He played the clarinet in his high school marching band but no longer performs publicly. Rock bands he formed during his teenage years: The Tides, Paraphernalia. Koogle also likes to drive fast, although he doesn't do it much anymore. A trained mechanic, he worked his way through Stanford University rebuilding engines.

CARS A Toyota 4Runner, a Mercedes convertible, and an old Saab.

PEOPLE HE ADMIRES Bob Galvin and George Fisher, both former CEOs of Motorola, where he used to work in the operations and venture-capital groups.

Now, transforming Yahoo into a profitable business seems as natural to Koogle as rebuilding a car. "It's full circle for me," he says. "The whole process of taking raw parts and building something that runs is something that appeals to me."

What also appeals to Koogle is racing around a track at 120 mph—as he did recently at racing school for some, uh, R&R. At home, the divorced Koogle

kicks back by jamming on one of three vintage guitars he keeps in his bedroom. And when he can, he flies to his getaway home, across Lake Washington from Microsoft Corp.'s William H. Gates III, to see old friends from the Northwest.

These days, there's little time for such indulgences. Koogle is keeping pace with an Internet clock that moves faster than the sleekest racing machine. And he has to manage the wild expectations set for Yahoo, valued at \$9.1 billion on Aug. 25. "There are lots of people in Silicon Valley who start and end with 'How do I make lots of

money?' I'm not about that," says Koogle, who lived in a spartan one-bedroom apartment before moving in March into a modest house in Saratoga, Calif. "I'm into building businesses that make money." He hasn't done too badly for himself, either: His Yahoo stock is worth \$200 million. Not bad for a mechanic from Virginia.

*By Linda Himmelstein
in Santa Clara, Calif.*

biggest bets on the squares that will give you the best return. And Yahoo is the Double Jeopardy Square on the Internet."

Koogle had better hope so. Should the economic model for this emerging business start to fizzle, the coming competitive assault will be the least of Yahoo's worries. It could take years to turn the P&Gs

of the world into Net believers, placing Yahoo squarely on the come line. For now, though, all hands at the company's spartan headquarters are focused on the bout before them. And they know that even one misstep will be seized upon by a le-

gion of Yahoo wannabes. "There's a vast universe waiting for Yahoo to fall or stumble," says Michael Moritz, a Yahoo board member. If Yahoo doesn't gobble them up first.

By Linda Himmelstein in Santa Clara, Calif., with Heather Green and Richard Siklos in New York and Catherine Yan in Washington

Cover Story

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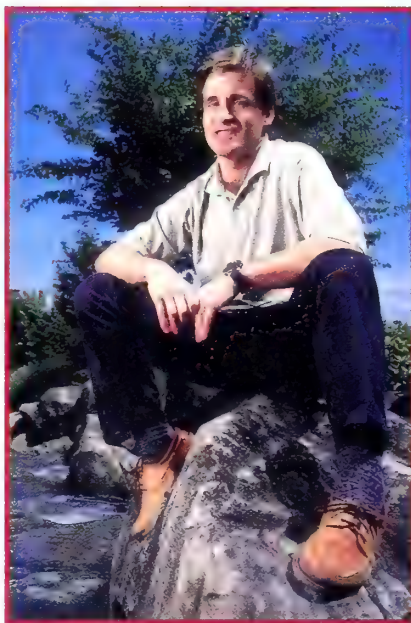
GUESS WHO'S OUT TO OUT-YAHOO! YAHOO!

Yahoo! Inc. may be the classic fleet-footed startup, but mighty Microsoft Corp. has achieved dominance by playing the tortoise, not the hare. Whether it's the Windows operating system or the Internet Explorer Web browser, both of which made real headway only in their third version, Microsoft has often succeeded more through persistence than through speed.

Now, the software king is setting its sights on the Internet's newest strategic prize: the portal, a super Web site that has so many services and so much info that it's the first place you visit on the Net. Microsoft right now is recasting its fragmented Web presence into one catch-all portal, after a six-month effort code-named Start.

The plan is to consolidate Microsoft's three separate consumer gateway sites into a single super Web site called MSN.COM and—after two mediocre tries—to finally turn the MSN brand into a cyberspace leader. About 2.5 million subscribers now use MSN for Internet access—far fewer than America Online Inc.'s 12.5 million. But by prominently featuring Microsoft's own popular Web sites, including Expedia travel and CarPoint auto sales, on the redesigned MSN.COM home page, the combination could be powerful, experts say. "Maybe three times is the charm," concedes wary Yahoo Chief Operating Officer Jeffrey Mallet.

HANDS ON. He should worry. For starters, Microsoft's new site will match many of the convenient features offered by Yahoo, AOL, and others, such as instant messaging and advanced search services. But Microsoft also will exploit advantages that rivals can't easily match. Consumers will be able to get to the portal by clicking either the Microsoft Network or Internet Explorer



OPERATION PORTAL

Top exec Higgins is leading Microsoft's charge into the Web-site business

er icons found on almost every Windows PC, so Microsoft will get the first shot at newbies. And the software giant plans to spend \$100 million to spread the word. "This is the focal point of our Internet strategy today," says Pete Higgins, group vice-president for Microsoft's Interactive Media Group.

The project is so vital to Microsoft's future that Higgins, an 11-year Microsoft veteran, is handling it directly. His strategy: to do the same standout job of integrating Microsoft sites in MSN.COM as he did when he oversaw the stitching together of the company's spreadsheet, word processing, and database programs into the Office suite. Today, that package holds a 90% market share.

Can Higgins hit another grand slam? A repeat of such high market share is unlikely given the runaway performance of Yahoo and AOL. But experts figure Microsoft can wangle its way into becoming a top-ranked portal. "If they can work it out, they will be a real competitor," says analyst Kate Delhagen of Forrester Research Inc. "And we think they'll figure it out."

HUNGRY FOR ADS. Microsoft is hardly starting from scratch. Despite its missteps with MSN, some 30 million people visit Microsoft's consumer sites each month, just 10 million fewer than Yahoo. The Expedia site boasts 2.5 million regular users, who book \$20 million a month in travel reservations, while CarPoint produces \$250 million in monthly sales through auto dealerships. Lumped together, Microsoft's family of consumer sites ranked sixth in Media Metrix' July list of top Web properties.

But Higgins' ultimate success will depend on whether or not he is able to turn that huge audience into profits. While Microsoft's Web revenues topped \$410 million during the fiscal year ended in June, much of it came from lower-margin Internet access fees—not more profitable E-commerce and advertising income. Indeed, analysts peg Microsoft's Web losses last year at more than \$300 million.

The new portal strategy should help turn that around. Higgins expects it will more than double ad revenues. According to Jupiter Communications Co., Microsoft netted \$20 million in Web ad revenues last year—one-third what Yahoo took in. "Advertisers follow eyeballs," says Jupiter analyst Peter Storck. If so, the tortoise could be lacing up some track shoes.

*By Steve Hamm
in Redmond, Wash*

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HOW LOWER RATES LOWER THE BOOM

They hurt retirees most, but as they persist, other investors and businesses start taking hits, too

What's not to love about lower interest rates? Borrowing costs go down, mortgages are cheaper, companies pay off their debts sooner, the economy grows faster, and everybody's happy, right? Not quite. For all the hosannas heaped on lower rates, people and companies are being hurt. And as rates continue to slide, the pain is sure to grow more severe.

Of course, those who suffer most are the millions of retirees who rely on short-term fixed-income investments, such as certificates of deposit. But they're not the only ones whose fortunes depend on a steady stream of income. Indeed, lower rates are depressing the income stream of a diverse group of investors, companies, and industries.

REFINANCE FEVER. The decline in rates is already beginning to wreak havoc on a good chunk of the \$2.3 trillion in public mortgage-backed debt. Mortgage-backed securities are supported by pools of mortgages, either residential or commercial. Aren't lower rates good for mortgages? Sure, for people who want to originate or refinance one. But when rates fall, investors in securities that have existing mortgages as collateral suddenly find mortgage holders prepaying their debt by refinancing. That means the value of the mortgage-backed security falls because investors no longer earn the higher interest rate.

Until recently, it was just mortgage-backed securities sporting interest rates of 7.5% or above that were experiencing higher-than-expected prepayments. But now, the market is waiting for the next shoe to drop, says Ken Boertzel, who manages about \$5 billion in mortgage securities at New York Life's asset-management business. The market is primed, he says, for an explosion of prepayments on 7% securities if the 10-year Treasury note trades around 5.25%—close to



where it is now. So far, that hasn't happened, and mortgage rates have remained fairly stable. But people seem more willing to refinance today, and the costs of refinancing are much cheaper. "There is concern that some very recently issued mortgages will start to prepay," says Michael Cloherty, a bond strategist at Credit Suisse First Boston Corp.

While long-term Treasury bond funds have sparked in recent months, returns on mutual funds specializing in mortgage-backed securities, such as those issued by the Government National Mortgage Assn. (GNMA), are dwindling. Through July, the 136 GNMA funds tracked by Morn-

ingstar Inc. were underperforming the Lehman Brothers Fixed Income Aggregate Index by about 2%, with the average fund returning 3.4% and the worst performing fund up less than 2%. The results for August are sure to show even further deterioration.

Things are a lot worse for institutional holders of "interest-only" strips, which are securities that isolate the interest payments on mortgages from the principal payments that also flow into the securities and pay only the interest to investors. "Under falling rates, IOs would take most of the beating, and that has been the case in the past few days," says Tae H. Park, a vice-president at Chase

curities Inc.'s mortgage-backed-securities research department. Park points to issues such as Federal National Mortgage Inc., or Fannie Mae. Such agency issues backed by 7% coupons lost 5% of their value in the past week, says Park. Those issues have lost 30% of their value since the beginning of the year. Individuals aren't the only ones who are hurt. Much of the record amount of corporate debt issuance in 1998's first half is for corporate refinancings. "It's a big problem for corporations, but for people who need those bonds, they got an attrac-

sales have already been declining as rates have come down, she says. Also, if a traditional life-and-health insurer derives its earnings just from excess cash flow, then when interest rates drop, the yield on its portfolio drops as the company invests new money, and money from maturing bonds, at lower rates. With a flat yield curve—meaning that long rates aren't much higher than short rates—it becomes difficult to earn a decent return on new business.

Home-equity lenders such as Advanta, Ameriquest Financial, and United Cos. Financial are also seeing a dark side to

may come via defined-benefit pensions. If rates stay at low levels or fall further, actuaries may have to start lowering the rates of return they assume when calculating how much more money companies need to pony up to adequately fund their plans. Granted, those are long-term projections, so adjustments aren't taking place yet. But "with today's rates so low, my expectation is that there will be some lowering of long-term blended return expectations, because that certainly seems to be the trend today," says Arthur Andersen partner Alan A. Nadel.

DANGER ZONE. Where an impact from lower rates may show up sooner is in the pension liabilities that defined-benefit plans report at the end of the year. As rates drop, the Securities & Exchange Commission requires that corporations measure their liabilities against the lower market rates. For underfunded plans, that may trigger onerous requirements and mean pumping more money into plans. "We are telling our consultants to warn clients about this when they are preparing their cash budgets for 1999," says Ethan E. Kra, chief actuary for consulting firm William M. Mercer Inc. So far, a rising stock market has offset any impact from lower rates, since most pension funds are 60% invested in equities today. "The possible danger is: What if we get a recession and a real stock market correction at the same time that rates are low?" says Alan Parikh, a principal at Chicago Consulting Actuaries.

But of more immediate concern to a broad swath of investors is the impact of lower rates on the cash flow from short-term investments. Take a retiree following a system of withdrawing 5% a year who has been earning a 6% to 7% yield on his two- and three-year CDs. With inflation at 2%, they're just about holding their portfolio value steady. "But with interest rates in the 5% range, and with CDs maybe falling to 4%, these people are going to be eating into principal," says Lou Stanasovich, president of Legend Financial Advisors Inc. in Pittsburgh.

It's not just retirees who need to take a harder look at spending and savings levels if lower rates become a long-term reality. "I'm a baby boomer, and I expect relatively low real rates of return on savings for the rest of my life," says Robin Grieves, director of fixed-income research at HSBC Securities Inc. Undersaved boomers who had planned on retiring in 10 to 15 years may have to make a significant change in lifestyle in order to meet that goal now, he says.

Most Americans are rooting for a further decline in interest rates. But while they cheer, a lot of other people will be paying a price.

By Suzanne Woolley in New York

AS INTEREST RATES TUMBLE...



...HERE'S WHO GETS HURT

retirees who rely on a stream of income from short-term, fixed-income investments, such as certificates of deposits, will suffer from lower rates.

Mortgage-backed securities investors, retail investors in Ginnie Mae funds to institutions owning "residual only" securities get hurt.

A bonds take a hit as homeowners pay mortgages; IO income dwindles as payments are made on a smaller amount of principal.

- Life insurers see sales of traditional life and fixed-annuity products fall, and the yield on their portfolios will shrink. Some finance companies may need to lower equity on their books if prepayments speed up further.

- If lower rates persist, companies with defined-benefit pension plans may have to change the formula used to determine the contributions they make to plans, so they may need to allocate more money to those plans.

DATA: BUSINESS WEEK

the investment called away," says Cloutier. Sure, a decline in rates raises the value of a bond. And bondholders are doing pretty well in terms of capital appreciation. That does little good, however, if the bond has a call provision.

While falling interest rates give businesses a boost by letting them lessen interest payments, certain industries will take a hit. Insurers with large portfolios of traditional life insurance, such as American General, and Liberty Mutual, may be feeling the heat. Low rates make it tough to sell products that make long-term fixed-return promises, such as universal life and fixed-annuity products, says Joan Zief, an insurance analyst at Goldman, Sachs & Co. Fixed-annuity

lower interest rates. Some of these specialty-finance companies, already suffering from greatly increased competition, take another blow if prepayment levels on mortgage securities they have packaged and booked on their balance sheet speed up even further. Many smaller specialty-finance companies use "gain on sale" accounting. That lets them record profits they expect to receive over the life of a loan at the time that they originate it. If a company counted on having the loan for seven years, and the loan gets paid off in three, the company has to lower its equity and take a write-off, notes Mark C. Alpert, an analyst at Bankers Trust New York Corp.

Another impact on Corporate America

A HUE AND CRY IN THE PIT

Commodities traders fear that an electronic system will wipe them off the floor

At the Chicago Board of Trade these days, there's a palpable sense of fear and loathing in the huge bond pit. It's not because business at the world's largest futures exchange is bad. Indeed, the financial crisis in Asia has the thousands of shouting, hand-waving traders executing record numbers of transactions this year.

The fear is of the future. On Sept. 8, Cantor Fitzgerald, the world's largest bond broker—and a member of the CBOT—plans to begin electronic trading in futures contracts on U.S. Treasury bonds and notes. The contracts represent about 50% of the CBOT's total trading volume. "We're going to offer the same service for about 75% less," says Howard Lutnick, Cantor's CEO.

Based on the experience of exchanges outside the U.S., the "open outcry" method of trading futures contracts pioneered in Chicago could soon be replaced by markets in cyberspace. That could profoundly affect the 150,000 people who work for the Chicago exchanges. "We've been amazed at the rapid acceleration of [electronic trading] in the last six months," says Patrick H. Arbor, chairman of the CBOT. The Chicago Mercantile Exchange has lost much of its currency business to electronic rivals and may soon face competition on its Eurodollar contract, which accounts for 48% of its volume.

QUICK WINNER. The experience of European exchanges is sobering. Last year, Matif, the French futures exchange, began trading its contracts on an electronic network at the same time as traders were buying and selling on the exchange floor. In that head-to-head battle, the open outcry pit lasted all of two weeks. Matif is now all-electronic. Even more unsettling is the experience of LIFFE, the London futures exchange. After losing its largest contract, the German bund, to the electronic



In Chicago, the price of an exchange seat has plunged close to 50% in the past year

Deutsche Terminbörse (now Eurex Deutschland), LIFFE announced plans to launch an electronic platform that will run concurrently with its floor. Many believe the London floor will disappear.

The Commodity Futures Trading Commission has yet to give regulatory approval to Cantor's plan, but few in the industry doubt that it will, despite lobbying by CBOT and other exchanges. Already, Cantor has more than 20,000 computer terminals on the desktops of bond traders, who are also bond futures traders. "There's going to be a lot of dislocation and a lot of angst," says Arthur W. Hahn, a Chicago lawyer with Katten Muchin & Zavis, who has represented the LIFFE exchange.

For years, Chicago's futures exchanges have argued that their open outcry systems were the most liquid

markets in the world and immune to cheaper electronic trading systems. But Hahn points out they "have been working in a monopoly environment. In the new world, there's going to be real competition."

A MONSTER? The CBOT, where the price of an exchange seat has plunged nearly 50% in the past year, is at least hedging against a possible electronic future. On Aug. 18, members voted to operate the exchange's overnight electronic network, Project A, during the daytime as well. "We're making a preemptive strike on any entity which might emerge as our competitor," says Arbor. The electronic trading will begin on Sept. 18. That's fine, says Lutnick. "They've signaled the demise of the pit in Chicago."

That's what traders, brokers, runners, and clerks in the bond pits fear. Jacob J. Morowitz, head of USA Trading, which clears trades for about 400 local traders at the CBOT and Merc, says the exchange should be enhancing the open outcry system, not replacing it. "They could be creating a monster."

Whether the monster turns out to be a predator or a savior remains to be seen. But it's clear that fear and loathing in the pits will persist.

By Andrew Osterland in Chicago

Market volatility is up, you're nervous, and your equity fund is in the doghouse. Is it time to sell? This is one of the toughest investment decisions to make. But in the investment world, selling is often the best course of action. Before you cut and run, however, review your plans, in the context both of the fund itself and of your overall investment plan.

Sure, you may feel like bailing out when the market is sliding. But if you have a long-term investment objective and have carefully made an asset-allocation plan and selected your funds, daily or weekly market gyrations shouldn't be your No. 1 consideration. And while it's natural to be frustrated with a fund that's los-

while its peer group—large-cap blended funds—gained nearly 22%. Why the lag? Friess built up cash in his portfolio in anticipation of a correction. It didn't happen, and the fund suffered.

Be sure to check whether your fund posted average returns with above-average risk. After all,



a year to recover, compared with its peers.

If you've given it adequate time and your fund is still lagging in return and risk, it's time to take action. But make one last check of these items to make sure your fund is really a dog:

- Review the fund's 1-, 3-, and 5-year total returns vs. its peer group.
- Look at its standard deviation (the variability of a fund's returns) and beta (its sensitivity to changes in the overall market).

against the fund's peer group. Also review the Sharpe ratio, a measure of risk-adjusted returns. It should be above 1.0. You can find such information at several investor Web sites, including S&P Personal Wealth (www.spglobal.com).

personalwealth.com) and Morningstar.Net (www.morningstar.net).

- **Examine your original investment plan** to see if the fund's objective still matches your long-term investment goals.

And don't forget the tax angle. If you've owned a fund for many years, you may have built up big capital gains. When you sell the fund, you will end up paying taxes on those gains. Fortunately, the long-term capital-gains tax is now just 20% for holding periods of 12 months or longer, so the burden has been eased. Paying the tax, however, reduces the earnings power of your fund investment by at least 20%. If the fund is trailing its peers by only a small amount, it may not make sense to sell. But if your fund is in a tax-deferred retirement account such as a 401(k), the tax question is moot.

It's far easier to buy a fund than to sell one, because selling represents a realization of your monetary loss and an admission that you may have made a bad investment decision. But selling a fund without doing your homework could be just as big a mistake.

Norton is managing editor of S&P Personal Wealth.

Having a sound asset-allocation plan should see you through a market slide

ing value or even moving sideways, make sure it's the fund and not the market sector that's the problem. For example, if you currently own a small-capitalization aggressive-growth fund, chances are its performance has been flat. The entire small-cap growth sector, however, has had difficulty recently: Look at the decline of about 12% this year in the Russell 2000 index. If aggressive growth is really your objective, you might have to wait out the sector's underperformance.

WRONG GUESS. If the sector you're investing in is moving higher but your particular fund is somehow being left behind, your fund manager may have made a major error. Consider the \$6.5 billion Brandywine Fund, managed by the highly respected Foster Friess. In 1997, the fund produced a return of just 12%.

you don't want to own a fund that doesn't compensate you in return for excess risk when compared with similar funds in its peer group. But don't unload it in haste, either. If your fund, like Brandywine, has had a string of outstanding years and just one period where it lagged, don't dump it. Every manager will make mistakes, after all.

If your fund has delivered superior returns over several years, you should give the manager the benefit of the doubt. Call and inquire about the poor performance. If the manager has left and returns have dropped, it may indeed be time to sell. But if the manager and the strategy remain in place, think about sticking it out. There are no rules on how long you should stay with a fund that is underperforming, but consider giving it six months to

IT'S JUNK, BUT NOT GARBAGE

Despite the market rout, an '80s-style crash is unlikely

It almost seemed like Michael R. Milken was riding high again. In the first six months of 1998, some \$117 billion in high-yield bonds were issued, nearly surpassing the recordbreaking \$120 billion for all of 1997. After eight years of seeking respect, high-yield was on the verge of shedding its junk aura.

Then came July. Stocks sagged, the economy slowed, and investors became anxious about unsettled conditions in Asia and Russia. When fear begins to overtake greed, the junk market is often the first to react. By the end of the month, the new-issue junk-bond market had stopped dead in its tracks. An estimated 20 deals have been scrapped or postponed. So far, only \$2.5 billion has come to market in August, the weakest month for new issues since September, 1996, according to Securities Data Co.

There's no reason to expect a junk-bond market crash like the one in the late '80s. Much has changed since then, when junk funded billions of dollars of highly leveraged transactions, many of which ran aground. Today's market features less leverage, more liquidity, and a more diverse group of investors.

FAT YIELDS. But the current carnage will likely be serious. With demand falling off, yield spreads on junk have risen dramatically, from 367 basis points over 10-year Treasuries to 434 since July 15, according to the Merrill Lynch Master II High Yield Index. What's more, default rates are rising—2.80% as of July 31, compared with 1.89% for the same period last year—although they are still below the 20-year average of 3%. “We’re likely to see some further widening of spreads and modest increases in defaults,” says Merrill Lynch & Co. global high-yield strategist Martin S. Fridson.

For investors in this falling interest-rate and low Treasury-yield en-

vironment, fat yields have been appealing. Indeed, junk bond funds have sported an annual return of 11.86% for the three years ended July 31, against 8.03% for the Lehman Brothers Aggregate Bond Index, according to Morningstar Inc. But higher yields mean higher risk. Despite bigger payouts, investors redeemed \$1.25 billion from high-yield mutual funds in the first three weeks in August, about the same amount that flowed into funds in July, according to AMG Data Services. “The last few years, investors who wanted bonds bought the highest-yielding ones. But that time has passed,” says Fridson. “Flight to safety doesn’t mean investing in high-yield bonds.”

Flight to safety has specifically meant investing in Treasuries and large-cap stocks as investors flee riskier areas such as emerging market equity and debt and small-cap stocks.

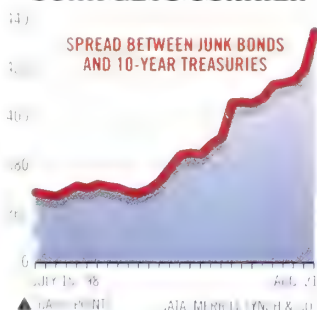
While junk bonds across the board have been hit, cable and broadcasting companies are holding up well. The most battered are cyclicals highly sensitive to recessions, such as chemicals, steel, energy, and paper, and telecom

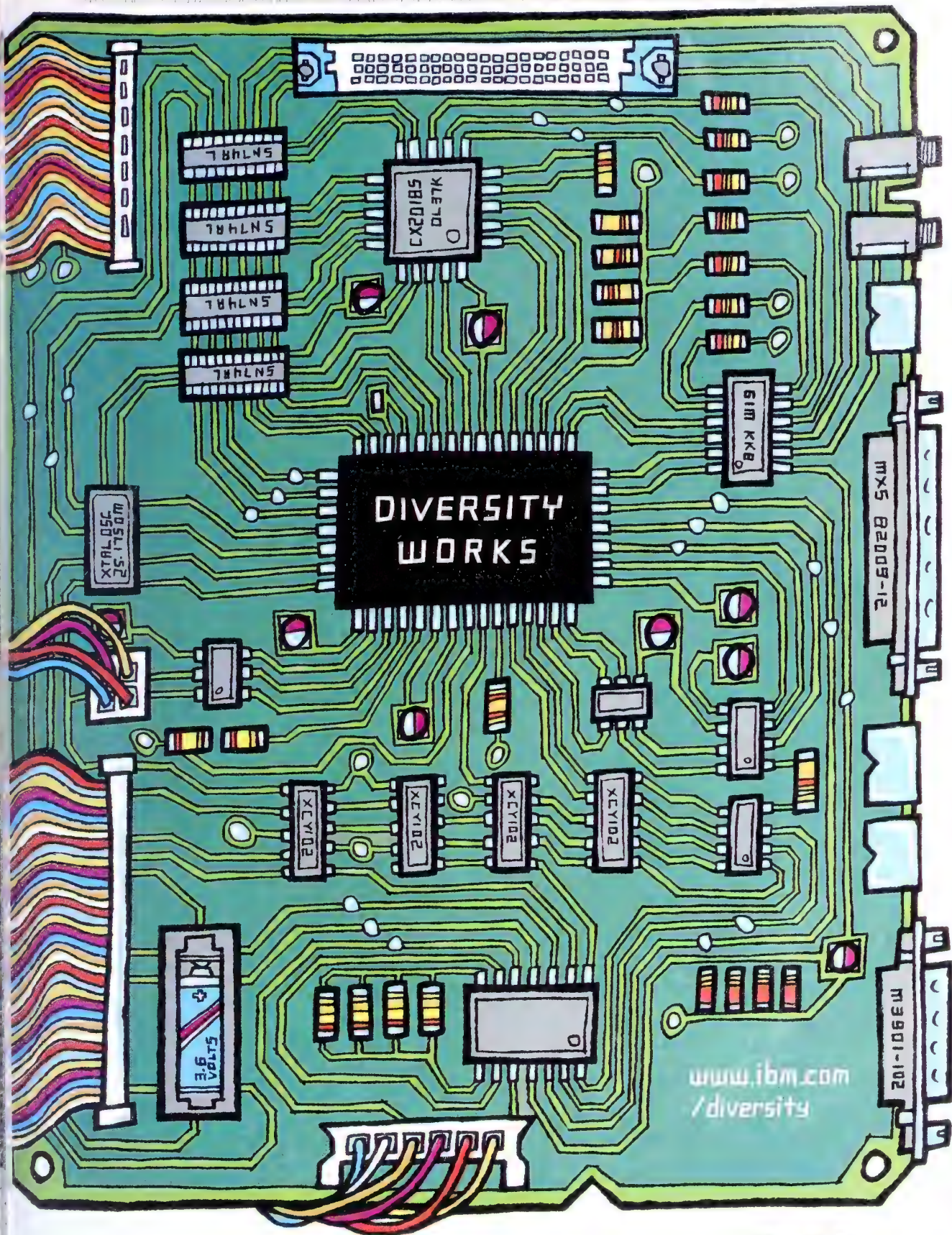
companies with no cash flow or earnings, says Douglas Forsyth, portfolio manager for Nicholas Applegate Capital Management’s High-Yield Bond fund. With the junk and initial public offering markets drying up, and banks unwilling to lend to companies with minimal assets, telecoms may need a deep-pocketed company to bail them out, says Fridson.

To be sure, most junk bond managers are relatively sanguine, despite the recent market rout. “After Labor Day, people will come back to see how prices have dropped, and there will be plenty of money to buy these securities and bid them back up,” says Harry Resnick, co-manager for Kemper High Yield Fund. Veteran fund manager Ernest Monrad of Northeast Investors High-Yield Bond fund says, “We like to buy when there is blood in the streets, and right now there is a little nosebleed. But it could be that the blood is just starting to flow.”

By Toddi Gutner in New York

JUNK GETS JUNKIER





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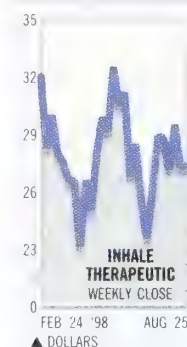
Solutions for a small planet

BY GENE G. MARCIAL

INHALE GETS SET FOR A BIG RUSH

Not many emerging biotechs have attracted as much attention in the past few years as Inhale Therapeutic Systems (INHL). Pfizer, Eli Lilly, and Baxter International have all invested millions in Inhale to develop a pulmonary device that would allow delivery of drugs through inhalation—including insulin for diabetic patients.

LOOKING WINDED LATELY



DATA: BLOOMBERG FINANCIAL MARKETS

Heiko Thieme, of American Heritage Fund, thinks Inhale will be a blockbuster in a few years. Notes Peter Ginsburg of Minneapolis investment firm Piper Jaffray: "Inhale's outstanding—but low-risk—opportunity in pulmonary delivery is undervalued by the market."

Inhale already turns out dry-powder formulations of medicines that, through a proprietary inhaler, are delivered into the lung and bloodstream. Sales of drugs that can be switched to the pulmonary route could top \$10 billion, estimates Ginsburg. Since 1995, Pfizer has shelled out \$10 million to fund Inhale's insulin product.

Pfizer, with a 5% stake in Inhale—bought at 25% above the market price—has conducted two clinical trials for inhaled insulin, with a third to follow in November. By the first half of 2000, Inhale could file for Food & Drug Administration approval.

In March, 1996, Baxter invested \$20 million in Inhale to co-develop compounds for Inhale's pulmonary system; Baxter owns an 8% stake in Inhale. Lilly paid Inhale \$10 million for an inhaled osteoporosis agent and another undisclosed compound.

In early September, Pfizer will report "further encouraging data" on inhaled insulin—at a meeting in Barcelona of the European Association for the Study of Diabetes, says Gins-

burg. Last June, investigators presented "positive data" from clinical trials at an American Diabetes Assn. convention. "Our studies showed that inhaled insulin can achieve the same excellent glucose control traditionally obtained from a regimen of several daily insulin injections," said Dr. Jay Skyler of the University of Miami.

IS A DEAL LURKING FOR LONGS DRUG?

Despite the market's slump, shares of Longs Drug Stores (LDG) have been on a tear since mid-August, zooming from 26 to 34 on Aug. 25. One explanation: On Aug. 19, Longs reported better-than-expected second-quarter earnings—and the stock rose three points that day. But it kept climbing.

"There's more to it than earnings," says Mike Kicera, President of MRK Capital Management in Rochester, N.Y., which has accumulated Longs shares. A West Coast chain of 349 drugstores, Longs "is ripe for a takeover in an industry that's rapidly consolidating." He adds, "Kicera has tagged several takeover targets before they were bought out, including American Stores."

Two rivals—CVS and Rite Aid—are interested in Longs, whose real estate is undervalued on its books, Kicera says. Based on recent drug deals, he figures Longs, with no debt, is worth well over \$40 a share in a buyout.

He speculates that the recent agreement by Albertson's to acquire American Stores may prompt CVS and Rite Aid to step up any plans to go after Longs. CVS has 4,056 stores in 24 states; Rite Aid 3,900 stores in 32 states. American Stores and Longs formed a joint venture last year, merging their pharmacy benefit-management units. This 50-50 project, called Rx America, serves about 400 health-maintenance organizations and insurance providers.

Kicera thinks that ultimately, Albertson's will want to widen the reach of American Stores' 800 Sav-on and Osco Drug outlets by acquiring Longs. Longs

SUDDENLY, A STEEP CLIMB



DATA: BLOOMBERG FINANCIAL MARKETS

Vice-President and Treasurer Clay Sealand declined comment on the takeover rumors but reiterated that the company is committed to staying independent.

FIRST HAWAIIAN'S MAINLAND TOEHOLD

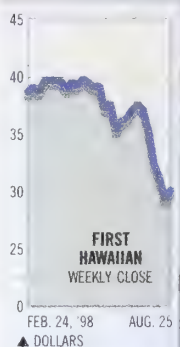
Two forces are pummeling First Hawaiian (FHNW), a bank holding company: its exposure in Asia and its acquisition of Bank of the West. First Hawaiian stock tumbled from 41 in late April to 29 on Aug. 25. Not to worry, says Deborah Beylus, banking maven at J.W. Genesis Capital Markets, a San Francisco investment firm. "First Hawaiian is the most undervalued and misunderstood bank stock around." Beylus' bullish stance isn't shared by most analysts. Others have either a hold or neutral rating on the stock.

Beylus thinks the Asian worries are overblown: First Hawaiian's loans in the region amount to \$109 million—or 1.3% of total assets.

First Hawaiian's acquisition of Bank of the West, says Beylus, creates a "diversified powerhouse, with assets of \$14 billion." Bank of the West, California's fifth-largest, has assets of \$5.8 billion and deposits of \$4.7 billion. It's profitable, with a clean balance sheet, she adds.

The merger will cut costs by \$23 million in 1999 and \$41 million in 2000—4% and 9%, respectively, of the combined companies' 1998 expenses, says Beylus. "These savings should add \$26 million after tax to earnings, or 45¢ per share," she says. And it gives First Hawaiian an entry into Northern California and a base for expanding mainland operations. Beylus expects the combined company to earn \$3.25 a share in 2000, up from an estimated \$2.75 in 1999. She thinks the stock, currently trading at a price-earnings ratio of 10.6, deserves a price of 15, or a price of 50.

WORRIES ABOUT ASIA SINK IN



DATA: BLOOMBERG FINANCIAL MARKETS

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STRATEGIES

TIME TO STOP BUYING -AND START SELLING

Federated is spending billions sprucing up its stores

In Manhattan's Herald Square, Macy's 96-year-old flagship is getting a face-lift. A restaurant is under construction, new floors have been laid throughout the store, and brighter halogen lights seem to illuminate every pile of towels. Even the merchandise is under re-evaluation. Next to the usual designer names, Macy's is increasingly hawking private-label brands created by its owner, Federated Department Stores Inc. From the rows of men's suits for young working women on the second floor to a bed covered with Charter Club striped damask sheets on the sixth, the company is showcasing its own labels. "This is what other stores won't do," says Feder-

ated President Terry J. Lundgren. "It takes a major commitment."

The Macy's makeover is part of a renewed push for top-line growth at Cincinnati-based Federated. Since emerging from a painful bankruptcy in 1992, the chain—which also owns Bloomingdale's and a flock of regional chains—has focused on two things: cutting costs to bolster profits and acquiring new stores to fuel growth. Spearheading the strategy was Allen Questrom, the smooth and stylish retailer whose remarkable ability to control spending and cut deals with vendors sparked the turnaround.

After Questrom retired unexpectedly in early 1997, his successor, James M.

HERALD SQUARE: *Growth must come from within the fleet of flagships*

Zimmerman, found himself facing a new problem. Survival was by then assured, but the new CEO needed to find a way to boost internal growth. For years, the focus was on cutting costs and not on sprucing up stores or basic merchandising. "They squeezed too hard," says Michael B. Exstein, a retail analyst at Credit Suisse First Boston. "They were overly cautious."

That's why Zimmerman, Questrom's soft-spoken protégé, is now zeroing in on boosting performance far closer to home. In addition to broadening brands such as Charter House from clothes into housewares and other areas, he is pouring \$2.3 billion into capital investments over the next two years. "The most important growth now," says Zimmerman, 54, "is growth from the stores we have."

BUYING SPREE. The changes are coming none too soon. Sure, Federated's earnings have more than doubled, from \$635 million in 1995 to \$1.34 billion in 1997, on sales that have soared from \$8.3 billion to \$15.7 billion. But most of that growth has come from rapid-fire acquisitions: In 1994, Federated swallowed Macy's for a total of \$4.1 billion, then bought Broadway Stores the next year

The Corporation

for \$1.6 billion. With no further acquisitions on the horizon, analysts expect sales growth to slow quickly.

The push won't be Federated's first transformation. In the late 1980s, burdened with debt by then-owner Robert Campeau, the mercurial Canadian financier, Federated's service and merchandise suffered as the company squeezed cash to make interest payments. By 1990, it was in bankruptcy.

That's when a generous pay package lured back Questrom, a Federated lifer who had gone to Neiman Marcus when Campeau took over. Together, he and Zimmerman, who began his Federated career as a salesman at a Houston store in 1965, focused on improving each store's return on investment.

They sold underperforming stores and exited lower-margin merchandise such as consumer electronics. Financial controls were tightened, and extensive point-of-sale bar scanners were added to let Federated tally prices and keep close tabs on inventory. Questrom's strong

Corp. in Chicago, which holds about 5 million shares of Federated stock.

Still, Zimmerman and his execs have plenty of work ahead. Of particular concern is Federated's sales growth in stores open for more than a year. An anemic 2.7% last year, that growth is a full percentage point less than prime competitors St. Louis-based May Department Stores and Birmingham-based Proffitt's Inc., which recently purchased Saks Fifth Avenue. Both have benefitted from their consistent ability to stock popular products at the right price and time—and neither has been distracted by anything like Federated's financial difficulties.

Moreover, Zimmerman will have to boost those numbers at a tough time for the industry. Department stores continue to lose market share to discount



ZIMMERMAN: Can he win back the young?

the baby boomers who are department stores' core shoppers. "We're going to stay with it until the whole store has changed," says Lundgren, who says an entirely redone test store should open sometime in 1999.

Another top priority: continuing to add to Federated's stock of private brands. With margins that average 2% higher than what Federated makes on outside brands, private labels have been Lundgren's biggest success so far. They are now

15% of Federated's wares, or \$2.3 billion in sales last year, up from 5% three years ago. But Lundgren doesn't plan to go beyond 20% of sales.

That's because Federated, in boosting its own labels, is competing more and more with the national brands that are its main suppliers. And the risks of missing a fashion trend are greater

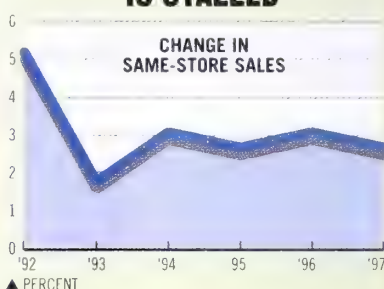
AS COST-CUTTING TAKES HOLD...



...FEDERATED'S STOCK TAKES OFF...



...BUT GROWTH IS STALLED



DATA: COMPANY REPORTS, BLOOMBERG FINANCIAL MARKETS, J.P. MORGAN SECURITIES, BW ESTIMATE

relationship with vendors helped him win money-saving concessions such as having vendors put clothes on hangers before delivery. And as earnings recovered, Questrom paid down debt, shaving off \$70 million in interest payments in 1997 alone. The result: Net margins blossomed from 1.9% in 1992 to 3.7% last year, sending the stock soaring. Up more than 300% since emerging from bankruptcy, it now trades around 52.

LOOKING DOWDY. Questrom, 60, retired early last year to travel and pursue other interests. This winter, he filed suit against Federated, claiming he is owed \$47 million in compensation miscalculated in 1995. Neither Questrom nor the company would comment on the suit.

But the turn of events has not weakened investor support for Federated. "We think they have one of the best management teams in the retailing industry," says Jerrold K. Sensor, a portfolio manager at Institutional Capital

stores and other venues. Among younger consumers in particular, department stores are generally as out of style as last year's merchandise. Questrom points out that it will be hard for Federated to grow faster than the economy's 2% to 3% expansion without further acquisitions. "It's not possible for a mature company to get much out of that range," he says. "That's what they'll have to live with."

While not ruling out an acquisition, Zimmerman prefers an internal focus. To lure customers back, he plans to spend \$1.6 billion renovating Federated's 400 U.S. stores, many of which had gotten somewhat dowdy during the cost-cutting years. A big chunk will go to spiffing up the chains' flagships in hopes of making them must-stop stores.

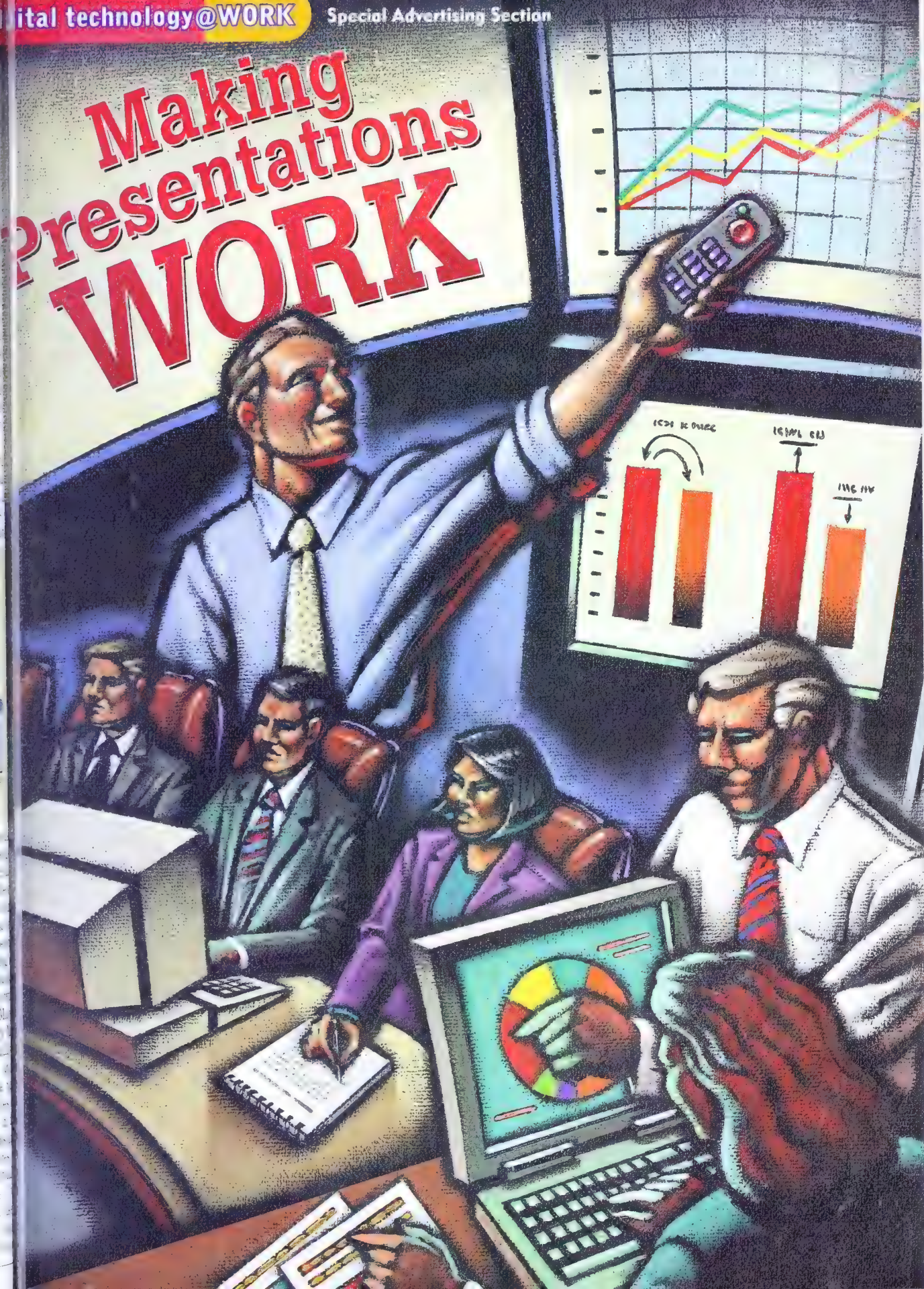
To attract younger shoppers, Lundgren has selected a team of execs to rethink Federated's format. The idea is to target younger buyers without alienating

when the store owns the merchandise. "The private label is a double-edged sword," says Maurice Marciano, chairman and CEO of Guess? Inc., a Federated supplier. "It's great when it's done well, but when you miss, it costs a lot."

Zimmerman is also investing heavily in such alternative ways of selling: the Net and mail-order. An expanded macys.com will move beyond showing goods to selling products online. Macys also plans to copy the Bloomingdale's By Mail catalog, which generates \$150 million. Together, the moves should add about \$700 million to revenue over the next three years, a 5% boost to sales. A small step, perhaps, but a step in the right direction. "It used to be fashionable to paint department stores dead," Zimmerman says. "Actually, they've been quite flexible, the chameleon of retailing." Spoken like a man in the midst of changing his color.

By Peter Galuszka in Cincinnati

Making Presentations WORK



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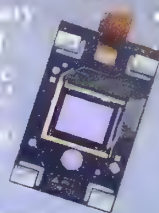
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overload? Simple; they just tune out.

According to New Media Research, there are 1.4 million presentations made every day in the U.S. So if you're going to get your message through to your audience, you must first get their attention, and then hold it. There's no magic to this; it takes planning, practice, and presentation skills. On the following pages, you will find some ideas on how you can make your next presentation more effective at getting your message across to your audience.

A LIGHT, BRIGHT IDEA

www.infocus.com

The LP425 projector from nFocus is a brighter version of award-winning LP420, with the same compact package and 6.8 pound weight, but with an increased brightness rating of 700 lumens — brighter than many projectors weighing two or three times as much.

The light weight makes the new projector an appealing choice for a number of portable applications. Jean Statler of Worthlin Worldwide has discov-

ered firsthand what a difference this can make. "With our older, heavier projectors, there were times when we didn't bother taking it with us. The LP425 weighs so little, that it's no problem to take it on every trip."

The brightness is the surprise benefit. When Statler was scheduled to make a presentation at a hotel, "the facilities staff insisted on using their own projector, but the image was so dim that the hall lights had to be turned almost all the way down for the images to be viewable. It was

too dark for the audience to take notes. When I offered the LP425, they didn't think it could do any better. But they were amazed that it was so much brighter



than their larger projector."

Statler believes that her company is saving money and making more effective presentations with the LP425. "We work with market research data, and our presentations can have 100 to 120 slides. Color transparencies are produced by an outside source and are expensive to make, and if you discover an error, there may not be time to get a replacement made. The projector lets you fix typos and make changes to your



InFocus® Personal Presentation Solution

presentation, right up until the last minute."

The result is that the LP425 has become an integral part of her company's operations. "With a staff of 20 people, the projector is out three to four days every week... so we're planning to buy a couple more."

PUT COLOR ON YOUR TEAM

www.epson.com

With all the technology available to computer users today, you probably wouldn't think of projecting black and white images to support your presentation these days. But all too often, users still hand out black and white notes or copies of their presentation images. When you think about creating powerful presentations, Epson America suggests that you think beyond just your computer and projector, and consider a team approach to the development process.

To deliver your message effectively, you need to use a variety of tools. For example, the Epson Stylus 850 color ink jet, the PhotoPC 700 digital camera,



836XL color scanner can work

together to pack more punch in your presentations.

For example, you may have content that you want to include in your presentation, but it may not exist in digital form. You can take existing photographs, logos, and other custom artwork and scan it using the Expression 836XL. Its 12.2 by 17.2 inch tabloid-capacity scanning bed makes it easy to scan oversize originals, and the 36-bit color depth with 800 by 1600 dot per inch resolution lets you create detailed and true color images.

Sometimes you just can't fit the original on a scanner, such as a building or a room or a piece of equipment. The PhotoPC 700 camera boasts 1280 by 960 pixel resolution, giving you enough detail to crop an image and still have an image that will show well in a presentation. A 2x digital zoom feature helps you frame your pictures as you take them, and the camera accepts different lenses for the ultimate in flexibility. The camera even has video output.

And when it comes time to give your audience handouts to reinforce your presentation content, the Epson

Stylus 850 provides plain paper color that is as vibrant and arresting as the colors you project on the screen. With 1,440 dot per inch resolution, your images will look even sharper than they will on the wall.

Start to finish, make the most of your opportunity to reach the minds of your audience. An integrated approach making full use of tools such as the cameras, scanners, and printers offered by Epson can help make sure that your message hits the target.

PICKING A PROJECTOR

www.nec.com

When you plan a meeting — whether it's a Monday morning staff get-together to review the status of current projects, or a



Epson Stylus 850 Color Ink Jet Printer.

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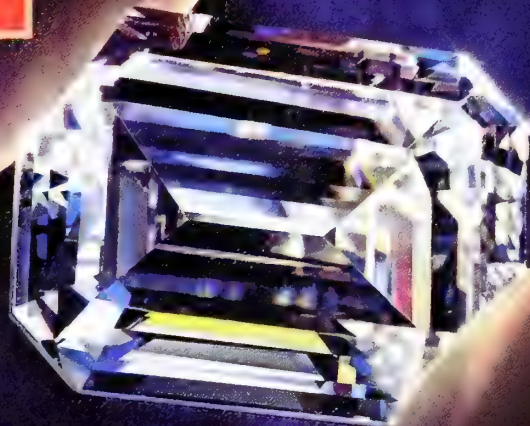


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NEC LT80 projector, remote, and case

major presentation for all of your best customers — you are careful to pick the right setting. Size, location, furnishings, facilities, and cost all have an impact on your choice.

In the same way, you want to make sure that you have the appropriate support devices on hand to deliver the maximum impact from your presentation. And when it comes to LCD projectors, NEC Technologies stands ready with a wide range of MultiSync projectors that fit a wide range of settings and circumstances.

For example, a mobile sales professional needs a lightweight projector that is simple to operate. Computer-based presentations are getting more and more complex with soundtracks and digitized video clips, so the projector needs to have sound support. It will only be used with a single computer at a time — usually a portable — so the connections and controls can be simplified.

In contrast, a projector intended for use in a training facility needs to be ready to accept signals from a range of input devices, including computer data and video, switching

effortlessly between them. It needs to be able to handle different image resolutions, and must be easy to operate remotely. And most important of all, the projector has to be bright enough that you can leave the room lights on; not only

does this help the participants take notes on the content, but it keeps the “snooze quotient” lower for after-lunch sessions.

The prompt sharing of information has become a vital part of business today, and companies are moving away from the traditional large screen televisions and slide projectors to the more immediate and versatile LCD projectors. NEC understands that choosing the right projector depends on understanding the application, whether it's for boardroom presentations or for high-resolution control room installations.

A SUCCESSFUL IMAGE

www.pioneerusa.com

Image is important to any business, but for Jim Hackett, the image is everything. His company, Show Systems of Valencia, California, provides business and industry with display solutions for applications ranging from

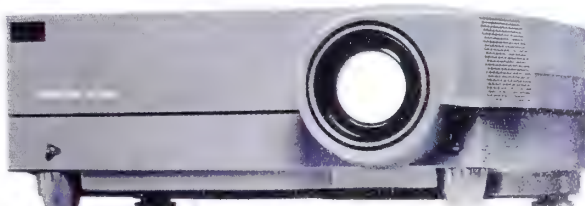
boardroom presentations to complex multimedia displays for major entertainment venues. “Our clients need projectors with bright light output. The image has to have terrific color balance and depth. We need to project images that can really reach out and ‘spank’ the screen.”

In the past, Jim has relied heavily on CRT-based projectors, but their low light output has severely limited their utility. But now he has something new in his bag of technical tricks: the Pioneer RVD-XG10.



Pioneer RVD-XG10 projector

This LCD projector is rated at 800 lumens, yet weighs less than 19 pounds and only uses a 150 watt lamp. Unlike traditional LCD projectors that block most of the lamp's light, the XG10 uses a special microdis-



NEC MT1020 projector

Business Week/September 7, 1998

with information, the

display. It's designed for

access — and use no more than five or six lines of text per image

THE BRIGHT BELLE OF BELL SOUTH

www.philipslcd.com

BellSouth Telecommunications has earned its leadership position in the South through state-of-the-art technology. But this poses special challenges for the company's training facilities; Philips ProScreen 4600 projectors are an important part of the solution.



Philips ProScreen projector.

"We know that projectors are worth their weight in gold for training, but they have always been far too cost-prohibitive and cumbersome," says Ed Coon, manager/team leader for BellSouth Telecommunications. "Now, with Philips ProScreen projectors, we have state-of-the-art technology in a portable unit and at an affordable price."

The trainers needed to create images that were large enough for the entire class to view comfortably, with sufficient resolution to show the detailed images required by the CAD software. And the image had to be bright enough that it could be seen with the room lights on. According to Coon, "The Philips projectors were the only portable units we found which offered such brilliant resolution."

Philips projectors use Ultra High Performance (UHP) lamps, technology that was developed by Philips to provide brighter images and longer lamp life with better efficiency than standard metal halide lamps. The ProScreen 4600

Endurance model has a lamp rated for 8,000 hours of use which can lower operating costs to nearly one-fourth that of conventional lamps.

BellSouth has also learned that they can depend on Philips for support. "Within less than two hours after a lamp failed, our Philips dealer CMS had a loaner Philips projector to us so our class could continue, and within 24 hours Philips had a brand

new ProScreen projector to replace the other unit. Now that's impressive service," says Coon. ■

play panel — developed by Pioneer — that reflects the light. Pioneer's Digital Reflective Imaging (DRI) technology can use as much as 92 percent of the light from the lamp.

As far as Jim Hackett is concerned, the proof is on the screen. "We get strong blacks and solid whites for wonderful contrast. It's remarkable how clean the image is, especially for text and spreadsheet images that require exceptional detail. The reflective technology smooths the image between pixels so you don't see an image made up of 'tiny colored bricks' like you do with many LCD projectors. The projector sells below the \$10,000 price point, which makes it attractive for many business presentation applications. We get CRT image quality at high brightness and a great price."

Jim also recommends the Pioneer XG10 to business professionals because of its ease of use. And thanks to its light weight, the unit offers traveling professionals a portable display solution.

Start and Finish Strong

musicians will tell you that the key to making the most of a solo is to start strong and finish strong. The same holds true for a presentation. Start with your energy up and your best attention-grabbing material, and you'll have a strong impact so the audience understands the point that you want to make.

This supplement was prepared by Knowledge Industry Publications, a subsidiary of Phillips Business Information, Inc., publisher of *AV Video Multimedia Producer* magazine.

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PORTALS OF POWER

Franklin Haney (left) paid ex-Senator Sasser \$1.8 million for help on real estate deals like the Portals building (above). Now, four probes are looking into Sasser's role.



ESTIGATIONS

OUGH QUESTIONS OR AN AMBASSADOR

Does Sasser may step down as envoy to Beijing. Why now?

Once former Tennessee Senator James R. Sasser was settled in as U.S. Ambassador to China, it didn't take long for Franklin L. Haney, his good friend from Chattanooga, to pop up in Beijing. In the fall of 1996, Sasser rolled out the red carpet for Haney and his wife: They were in the ambassador's residence, picked at the Great Wall, and took shopping trips to the cashmere markets and silk stalls.

And why not? Franklin Haney is well connected in Washington. For starters, he's a longtime friend of Al Gore and served as an aide to the Vice-President's father, Albert Gore Sr., when he was U.S. Senator from Tennessee. Now a prosperous real estate developer, Haney had also been a generous contributor to Sasser's four Senate campaigns and had employed Sasser in the

year between his upset loss and his confirmation as ambassador. Sasser even worked out of Haney's Washington offices, just a stone's throw from the White House.

But those 12 months, and the \$1.8 million Haney paid Sasser during that period, may come back to haunt the ambassador. The Justice Dept., the State Dept., and House and Senate committees are all looking into various aspects of Sasser's work for Haney, and whether it was properly disclosed.

Earlier this month, Sasser "unofficially" notified the State Dept. of his desire to leave Beijing at the end of the year. Why resign such a high-profile post just 2½ years into a surprisingly successful tenure? Sasser's decision is based on personal reasons and has nothing to do with his work for Haney, says Sasser spokesman James Pratt.

But sources say that Justice is investigating two of Haney's real estate deals in which Sasser served as an adviser. One involves a Haney-owned building in Chattanooga that is leased to the Tennessee Valley Authority and the other a controversial government lease on the Portals II building in Washington, half-owned by Haney.

A State Dept. official says Sasser's major problem is that he did not disclose to the Senate or the State Dept. that Haney agreed to pay him a \$1 million contingency fee if a \$120 million construction loan for the Portals building went through. Sasser reported the payment once he received it, but by then he had been sworn in as ambassador. Sasser's problem is further complicated by the fact that he and Haney signed a retroactive agreement, stipulating how much Sasser would be paid, more than two weeks after his Jan. 11, 1996, swearing-in. On a financial disclosure form, Sasser also underreported his monthly income from Haney by a total of \$300,000, but he corrected the error in a recent memo to State Dept. lawyers, saying the omission was inadvertent.

Ethics laws require nominees to disclose all income, assets, and arrangements for payment. They also forbid federal officials from earning outside income once they are sworn in. Senate Foreign Relations Committee Chairman Jesse Helms (R-N.C.) on Aug. 20 asked State Dept. Inspector General Jacquelyn

L. Williams-Bridgers to investigate whether Sasser had violated ethics laws.

Separately, the House Commerce Committee's subcommittee on oversight & investigations is seeking Sasser's testimony as part of its 10-month investigation into whether Haney received favorable lease terms on the Portals in exchange for campaign contributions. Besides Sasser, Haney retained Peter S. Knight, formerly a top Gore aide and chairman of the '96 Clinton-Gore reelection effort, to work on the Portals lease. Knight, too, received \$1 million from Haney after the \$400 million Portals deal closed. Around the same time, Haney and his lawyer funneled \$250,000 to five state Democratic parties, whose records were subpoenaed in July by the Justice Dept. Haney, a lifelong Democrat who once ran for a Tennessee House seat, denies his donations played any role in the Portals deal or that any Democratic politician interceded on his behalf.

Still, it all adds up to one big legal headache for pol-turned-diplomat Sasser. Expectations were low when he first arrived in Beijing in the spring of 1996, still trying to master the nuances of U.S.-China policy and grappling with the language. But when the late June-early July summit between Presidents Clinton and Jiang Zemin went off without a hitch, Sasser got high marks. So his sudden request to return to the U.S. has taken China hands by surprise.

TVA TIES. Sasser, 62, spent 18 years in the Senate—six of them as Senate Budget Committee chairman. But Tennessee voters turned him out of office in the GOP onslaught of 1994. The blow was softened when he was nominated for the Beijing post. To top it off, home-state pal Haney agreed to pay him a \$100,000-a-month retainer. His assignment: work on several pending real estate deals while awaiting Senate confirmation.

One of Sasser's very first tasks was to help Haney persuade the Tennessee Valley Authority to renew leases on five Haney-owned buildings, including the 17-story Chestnut Street Tower in Chattanooga. In the summer of '95, Haney wanted the TVA—the federal agency that

is the nation's top electric-power producer—to renew the Chestnut Street lease for a second 10-year term even though, according to TVA documents, the agency's staff informally recommended terminating it as a money-saving measure. A lease worth almost \$17 million was signed that November anyway.



TAKING AN OATH: Gore swears to Sasser

THE SASSER FILE

JANUARY, 1995 Having lost his Senate seat, Sasser opens a law practice. Developer Franklin L. Haney becomes his major client, paying Sasser \$100,000 a month for help on government real estate deals.

AUGUST, 1995 Sasser and Haney meet with top GSA officials and ask for crucial changes in a lease on the Portals building, intended to house the FCC. Sasser later meets with top officials at the FCC and OMB, also on Portals issues.

SEPT. 22, 1995 President Clinton nominates Sasser to be ambassador to China.

OCTOBER, 1995 Haney says he and Sasser agreed verbally that Sasser would be paid a contingency fee if a \$120 million construction loan for the Portals building was finalized. Sasser does not reveal agreement in his confirmation hearings. And Sasser fails to report \$300,000 out of \$800,000 Haney had paid him.

DEC. 14, 1995 Senate confirms Sasser.

JAN. 11, 1996 Sasser is sworn in as ambassador.

JAN. 26, 1996 Sasser and Haney sign an agreement in which Haney will pay Sasser \$1 million for his 1995 work on government leases and the Portals building. Agreement is retroactive to Jan. 1, 1996—after Sasser's confirmation but before his swearing-in.

APRIL 26, 1996 Haney sends Sasser check for \$1 million.

Through spokesman Pratt, Sasser says he "may have" talked to TVA Chairman Craven H. Crowell about renewing the lease. Crowell had served Sasser from 1977 to 1983, first as press secretary and then as chief of staff. Sasser had interceded with the Clinton Administration to help Crowell get the

job in 1993, says a government source. Crowell, through spokesman, denies wrongdoing and declines to say if he ever discussed the lease with Sasser.

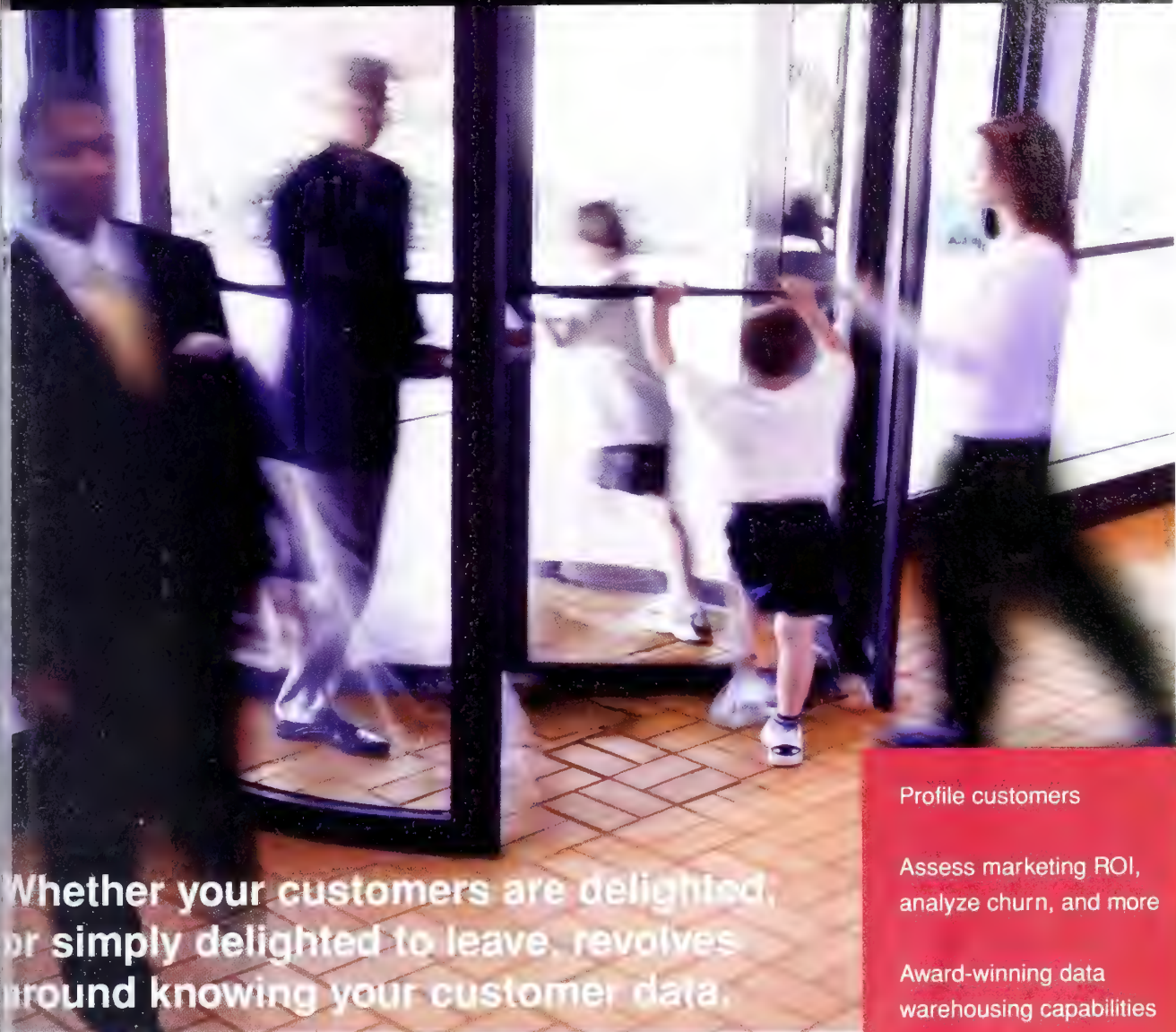
While a knowledgeable source says the Justice Dept. is looking into the lease renewal, Sasser's Portals dealings might be a bigger problem. Foreign Relations Chairman Helms wants to know if Sasser, in October, 1995, intentionally misled the Senate and the State Dept. by not revealing his work on the Portals.

Even then, the Portals was a controversial project, and Sasser's involvement might have raised eyebrows. At the time, the Federal Communications Commission was supposed to move into the Portals but was resisting. A succession of FCC officials and many of its employees disliked the building's location in southwest Washington. At the time, some congressional Republicans also didn't want the FCC to move, hoping instead to downsize the agency and loosen its grip on the telecom industry.

RESCUE. In mid-1995, Haney entered the picture, hoping to rescue the faltering project. But Haney wanted changes in the lease negotiated in 1994 by the previous developer, especially a fixed date for payments to begin and a clause guaranteeing the rent would continue uninterrupted even in case of fire or other severe damage. Haney wanted to finance the project by selling tax-exempt bonds, backed by the government's monthly rent payments, and both changes were needed for a favorable bond rating. To negotiate the changes, Haney or his representatives met over a dozen times with officials of the GSA and other federal agencies.

Sasser attended at least four of those meetings but failed to mention them during his confirmation. In the fall of 1995, for example, he met with the Office of Management & Budget officials

DATA: BUSINESS WEEK, CONGRESSIONAL TESTIMONY, STATE DEPT. DOCUMENTS



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on page 118

Government

who oversees the GSA and with the FCC Chairman Reed E. Hundt. (The FCC under Hundt agreed later that year to occupy the building but has since resumed its opposition even though the federal government has already paid out \$14 million in rent.) Sasser did disclose two meetings at the GSA to discuss construction of an office building "for partial GSA use." He did not say that the building in question was the Portals.

And Sasser failed to disclose other items. On Aug. 4, the same day a House panel made public a document showing Haney's payments to Sasser, the ambassador sent State Dept. lawyers a memo revealing that he failed to report \$300,000 of his 1995 income from Haney. Sasser wrote that the money "was inadvertently not recorded as a deposit in my law office's check register." An aide to Senator Helms says the committee was misled by Sasser about his Portals involvement. "It smells," the aide says.

ILLEGAL FEE? House Commerce Committee Republicans also consider several aspects of the Portals deal unfavorable. Haney insists the \$1 million fee paid Sasser was for his work in securing the \$120 million loan for Haney to complete the Portals project. But after sifting through thousands of subpoenaed documents, committee staff have found no proof that Sasser actually worked on the construction loan. And the "professional services agreement" in which Haney pledges to pay Sasser \$1 million refers to Sasser's work on the Portals lease as well as the construction loan. Says Joe Barton (R-Tex.), chairman of the House oversight subcommittee: "Sasser apparently had nothing to do with getting the loan and everything to do with getting the changes in the lease" crucial to the bond sale. Under federal law, it would be illegal for Haney to pay Sasser a contingency fee on a government contract.

Sasser denied to Senate and State Dept. lawyers that he had ever lobbied any federal agency while a private citizen. But on Aug. 4, Haney told the House Commerce subcommittee: "I needed somebody to get me taken seriously. Mr. Sasser gave me instant credibility. People would stand up when I walked into the room, and they would if I walked into the room."

Now it's Sasser's credibility that's at issue. After a long career in the State and a triumphant turn as a diplomat, at least four inquiries await the ambassador when he returns to the U.S. That is certainly not the welcome home he might have been expecting.

By Paula Dwyer in Washington

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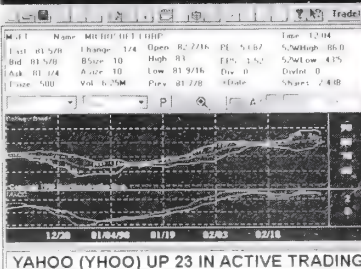
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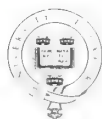
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CELL PHONES: EUROPE MADE THE RIGHT CALL

single digital standard gives it the clout to shape the next generation of wireless gear

These should be triumphant times for Qualcomm Inc., a scrappy pioneer of digital cell-phone technology. After struggling for more than a decade, the San Diego company sold the world on the merits of its digital technology. Revenues will exceed \$3 billion this year—a tenfold increase in four years. And in June, Europe and Japan decided to adopt Qualcomm's technology as the basis for their more powerful phones—"third generation" machines—that should be available early in the next century. But for Qualcomm, the victory is bittersweet. The company's top officers say the Europeans have tweaked the technology in a way that will reduce Qualcomm's royalty streams from its patents and make its phones less attractive overseas. Qualcomm officials have offered the Europeans a variety of proposals and compromises in which one side might prosper, but Chairman John E. Jacobs says its suggestions have fallen on deaf ears: "Our contributions were either tabled or ignored." Qualcomm's travails are part of the global struggle to settle on standards that will make a cell phone usable throughout the world. More than 10 years ago, European officials decided to implement a common digital standard, known as GSM (global

system for mobile communications). While America is a tangle of competing phone standards, bred by its laissez-faire philosophy, European governments helped to create a united front led by such giants as L.M. Ericsson and Nokia Corp. That alliance has soared to global dominance.

Now, as Qualcomm is discovering, Europeans may call the shots for the next generation of cell phones, which will be able to cruise the Internet and deliver live video in as little as three years. Qualcomm is crying foul and is asking Washington for help. But now and in the near future, Europe rules the world's radio waves. The outcome is

Phone Wars

In the fight over digital cell phones, Europe's committee approach beat America in the first round by advancing a single standard, while the U.S. gave competition free rein. In the next round, Americans may lose even more ground.

already evident in China, the world's fastest-growing cell-phone market, which increasingly takes its technology cues from Europe.

For the U.S., the costs of playing second fiddle are now painfully obvious. Dataquest Inc. figures that cellular subscribers worldwide spent upwards of \$37 billion on handsets last year. That number will shoot past \$55 billion in 2001. Washington-based market researcher Strategis Group says most of that growth will be in phones built to Europe's GSM specs—further enriching Nokia and Ericsson. Of the 98.6 million digital cell phones produced last year, 58% were GSM, according to Dataquest.

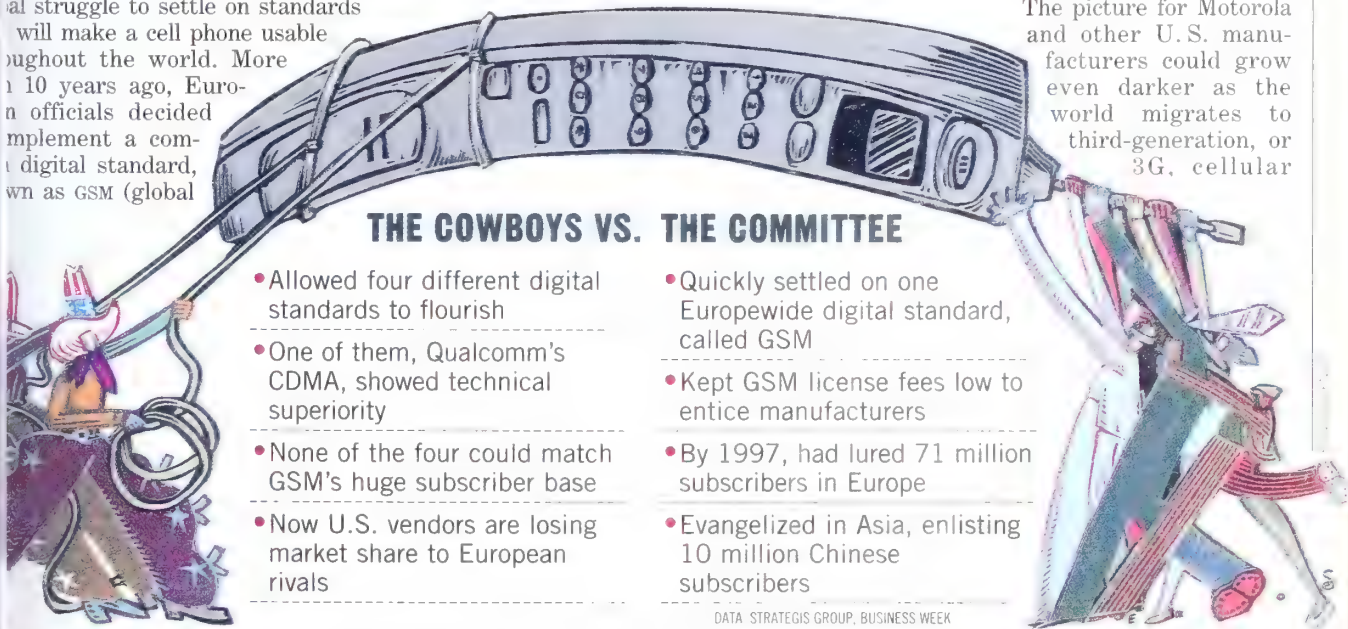
PARTY CIRCUIT. Europe's success has already bloodied Motorola Inc., which pioneered two-way radios, pagers, and cell phones. The Schaumburg (Ill.) company has fallen far behind Nokia in Europe and Asia. Even in North America, Motorola's market share has crumbled, falling from 60% in 1994 to 34% today, according to Herschel Shostek Associates Ltd. in Wheaton, Md.

The picture for Motorola and other U.S. manufacturers could grow even darker as the world migrates to third-generation, or 3G, cellular

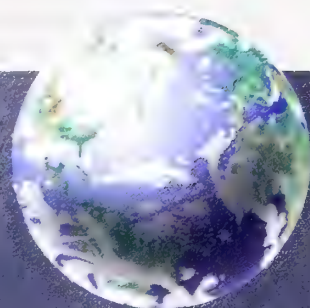
THE COWBOYS VS. THE COMMITTEE

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Europe has embraced Qualcomm's technology—but its standard bypasses some of the U.S. company's patents

phones. (The first two generations were analog and current-style digital.) In third-generation phones, data transmission will be front and center. Most of today's cell phones transmit at a top rate of 9.6 kilobits per second, but 3G phones will send data at up to 2 megabits per second—faster than the direct connections many people have at work, and easily fast enough to surf the Web and download software or movie clips. Eventually, product developers predict, 3G phones will even manage videoconferencing.

The phones are based on a technology called "code division multiple access," or CDMA. Concocted by the U.S. military and commercialized by Qualcomm, it spreads specially coded signals across a slice of radio spectrum, allowing many users to share the same scarce communications bandwidth. You can think of a CDMA network as a multilingual cocktail party: There are many conversations in progress, in different languages, and listeners can focus on one and ignore the rest.

It's no surprise, then, that both Europeans and Asians embraced CDMA for the third generation. But Qualcomm wants a standard that would be "backward-compatible" with its existing CDMA system. It felt slighted when in late January, the European Telecommunications Standards Institute (ETSI) endorsed a 3G CDMA standard that bypasses key Qualcomm patents and is incompatible with existing networks that use Qualcomm's CDMA technology. "They want a technology that lets them protect their home turf," says Jacobs. "Then they'll build that up and continue to export." Nothing would stop Qualcomm from making and selling phones based on Europe's new standard. But the company would suffer diminished patent revenues and lose its economies of scale.

GREAT LEAP? The Europeans say they weren't trying to dodge Qualcomm's patents—they simply focused on the best technology. "We wanted to make a major leap forward in terms of capability," says Ake Persson, vice-president for marketing and sales at Ericsson Mo-

bile Systems in Stockholm. "The standards group was not prepared to sacrifice that just to make the systems backward-compatible."

The truth may lie somewhere in between these two views. Certainly, Qualcomm is not without blame for its current predicament. The company has a reputation for setting license fees much higher than those the GSM group imposes on its members. "This has been spoiling the whole thing from the beginning," says Thierry Laurent, senior vice-president for communications products at U.S. chipmaker VLSI Technology Inc., an impartial supplier to all camps.

Nonetheless, Qualcomm's tale of woe dismays U.S. trade negotiators. Qualcomm executives note that voting power in ETSI is based on a company's sales. So Qualcomm ended up with only

prompted most of Asia, and even the U.S., to embrace the standard.

In the U.S., meanwhile, Washington encouraged competition. "Consumers are best served when the marketplace determines the standards it prefers rather than government-affiliated standards bodies like ETSI," says Federal Communications Commission Chairman William E. Kennard.

As America moves into third-generation phones, the market will be further split into four different technical standards. There's no way out, since today's service providers must assure backward compatibility with their customers' current telephones.

ULTIMATUM. Qualcomm insists that it has the resources and the legal right to build on its success. To do so, it is banking on its CDMA patents. On August 1, Qualcomm delivered an ultimatum

to ETSI: It would win the right to hold intellectual property rights in the standard unless ETSI agrees to a standard compatible with both European networks and American digital networks. Qualcomm also demanded that the standard be chosen on technical merit.

Europe attempted

to force Qualcomm to grant a license to its patents, Jacobs may request a World Trade Organization filing.

Washington seems prepared to back Qualcomm. The likely outcome is that ETSI, to preserve the peace, will shift for an accommodation that will reduce market-entry barriers for Qualcomm.

Meanwhile, the International Telecommunications Union has until next year to certify ETSI's proposal as a global standard. So there is plenty of time for negotiation. Europe is likely to weave some of Qualcomm's favorite technical specs into the new 3G standard. With that, Qualcomm will be able to boost its royalty revenues, which may give the company some satisfaction. But it won't be enough to give Americans the upper hand in the third generation.

By Steven V. Brull in Los Angeles and Neil Gross in New York, with Catherine Yang in Washington and bureau reports

QUALCOMM'S ADVANTAGE: THE 'SOFT HANDOFF'

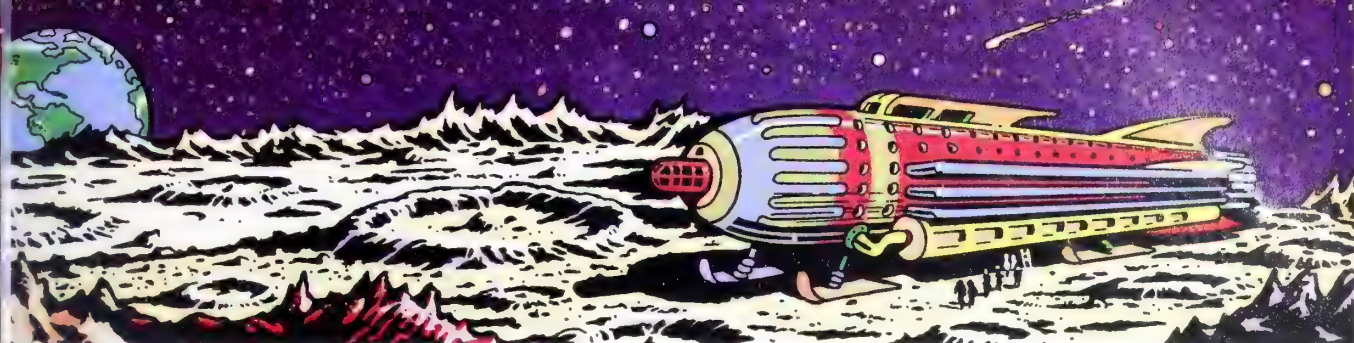


In analog and GSM cellular systems, the phone connection breaks momentarily when the call gets "handed off" from one cellular station to the next. CDMA systems create a new connection before breaking the old one, thus avoiding interruption—a critical point for data transfer.

one vote. Last November, when Qualcomm finally got a chance to put forth its ideas formally, its proposal was the last item on the agenda—and the meeting was adjourned before Qualcomm could make its presentation.

Fifteen years ago, the situation with Europe was reversed. The U.S. had just one cellular standard, and Motorola was in the driver's seat worldwide. With seven different analog standards, Europe looked more like America's own Wild West.

To impose order, European governments and industry adopted a common digital standard—GSM—in 1992 that, for the first time, enabled a mobile executive to roam with a cell phone from Stockholm to Seville. Since then, GSM has exploded, last month passing the 100 million-subscriber mark. Four new customers are now switching on a GSM phone every second, or 5 million a month. The result—manufacturing economies of scale and low prices—has



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Life on Easy Street arrives with a surprise: the walk can be hard. The celebrated "comfortable" life, it turns out, often is not.

A friend suggested this when he reminisced about his earlier life: when you have no money, he said, you never worry about what to do with it.

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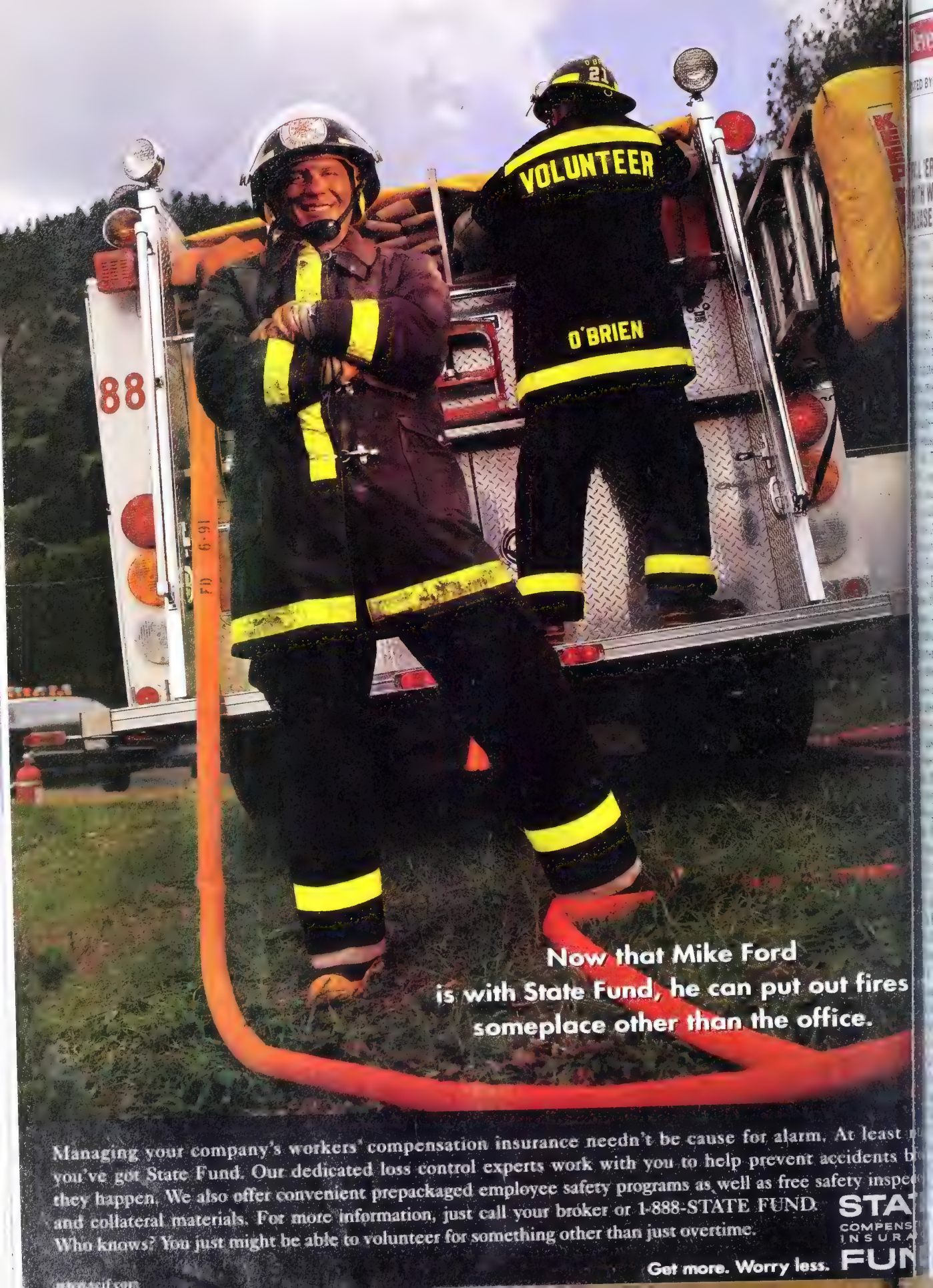


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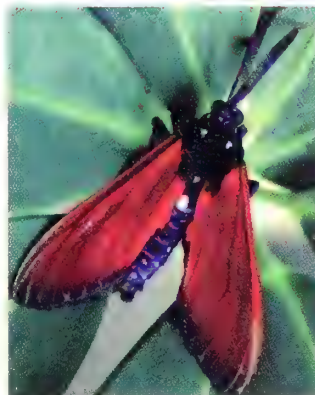
A FEW YEARS, YOU MAY be putting a corn cob in your tank—in liquid form. Stephen F. Paul, a Princeton University physicist, has developed a way to make gasoline substitutes from corn, beer, wood chips, and other biomass waste products—and slash noxious emissions to boot. Some 70% of the fuels' acid content comes from these materials. The rest is typically ethanol. Paul led the American Chemical Society's annual meeting in Boston on Aug. 23 to his P-series fuels (med for Princeton) reduce 40% to 50% fewer hydrocarbons—a key component of smog—20% less carbon monoxide, and less carbon dioxide than gasoline. Yet they generate 92% of the power of gasoline. These fuels won't be cheap, though. Paul figures they'll cost about \$50 a gallon at the pump. Still, he thinks the technology could serve as a high-volume insurance policy in the event of another oil crisis. The Energy Dept. believes they could displace 1 billion gallons of gasoline by 2005 and is considering adding P-series fuels to its list of approved alternative fuels. They can be burned by special "bi-fuel" vehicles already on the market, such as certain Ford Motor Co. Ranger pickups and Crown Victorias. Paul licensed his recipe to New York's Pure Energy Corp. *Catherine Arnst*

THE TIGER MOTH'S LESSON FOR THE PENTAGON

BATS ARE CRUISE MISSILES of the animal kingdom. They locate a target with a sophisticated sonar system, then hit it going 75 mph. Most prey never have a prayer.

Yet a moth from the Tiger family (photo) regularly escapes—because bats often veer away just as they are about to snatch a Tiger moth. Scientists have known about the moth's dramatic escapes for two decades, but how the moth does it has remained a mystery.

Now, University of Toronto



zoologist James H. Fullard thinks he has found the explanation: Tiger moths emit an ultrasonic clicking sound that closely resembles a bat's echo-location signal, or sonar. The clicks may jam the bat

sonar in much the same way that military jamming techniques confound enemy radar. Or the signals could prompt the bat to abort its attack for other reasons, since Tiger moths appear to be unappetizing—bats rarely devour the ones they do catch.

To decide the issue, a controlled experiment with trained bats will be staged this fall. The outcome could point the way to efficient bat repellents. And it might also pay off for the Pentagon. If moths can jam a bat's sonar, which is more accurate than the best military systems, the Pentagon will surely want to try to tame this Tiger. *Nellie Andreeva*

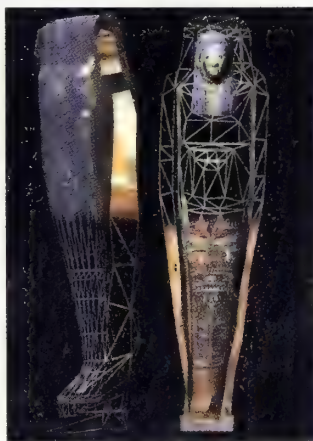
SAVVIER 3-D DESIGN SOFTWARE

CREATING REALISTIC, THREE-DIMENSIONAL COMPUTER models can be a chore. A lifelike representation of anything that has a complex or highly textured surface—such as a person's face or an upholstered recliner—can take days to produce with today's computer-aided design (CAD) tools. But it's a breeze with software from Synthonics Technologies Inc., says F. Michael Budd, president of the Westlake Village (Calif.) startup: "In

most cases, you eliminate 90% of CAD time and cost."

The software, dubbed Rapid Virtual Reality, automatically translates flat photos into 3-D replicas. It uses algorithms developed by Synthonics founder Charles S. Palm to construct a so-called wire-frame model from the photos, then wraps a photo around this skeleton.

Solid models will bring a new dimension to the Internet. Animations can be more entertaining, and



erstwhile static photos can become interactive. Models will also enable new online shopping gimmicks, says Budd. Surfers can pick up and examine products almost as if they were in a real store. People in the market for furniture could send in photos of a room and get back a model, then pull furniture from a digital catalog and place it in the model room. And for the Smithsonian Institution, Synthonics is making a CD-ROM with thousands of 3-D models of items in its collection. □

INNOVATIONS

■ An exercise pill? It just might happen. Researchers at the University of Texas Southwestern Medical Center in Dallas have found a genetic switch that tells muscles to behave either like the "strength" muscles seen in weight lifters or the "slow-endurance" muscles developed by aerobics enthusiasts. According to cardiologist Dr. R. Sanders Williams, a drug that would produce healthier muscles by mimicking the effects of exercise may now be feasible.

■ Total quality management (TQM) pays off handsomely. A study by Vinod Singhal at Georgia Institute of Technology and Kevin Hendricks at the College of William & Mary found that TQM award-winners posted 37% higher sales growth and 44% fatter stock prices, compared with a corporate control group. Those results buttress similar findings for the stocks of 18 winners of the Malcolm Baldrige National Quality Award. They have outperformed the Standard & Poor's 500-stock index by over 100%.

EDITED BY WILLIAM GLASGALL

HOW NOT TO SELL YOUR HOUSE

My daily commute from hell was the deciding factor. After yet another hour-plus delay heading into Manhattan on a New Jersey Transit train, I walked into our foyer that evening and said to my husband, Kevin: "We have to move closer to the city."

That was last May. It seemed a great time to sell. Mortgage rates were low, home sales were breaking records every month, and papers were full of anecdotes of bidding wars and houses selling within two hours of being listed.

Such hype is seductive, of course. And because I failed to recognize this, I made some crucial mistakes. This is not a tale for families who own dream houses. This is for those of us whose house is not the most marketable style or in the best location or school district. My tale is a confession of what I did wrong and what I will do differently the next time—if there is a next time, as our house still has not sold. I have learned that selling a house means you have to be prepared to do legwork, keep an eye on your real estate agent, be realistic about your property's faults, and—just maybe—believe in divine intervention.

Our first mistake was not deciding what was more important to us: time or price. For some sellers, getting the top price is the key concern.

They are willing to wait for the right buyer to come along. But for us, moving as soon as possible was paramount. A short selling period was more attractive than getting the best price. We had no idea, however, what that price would be. And pricing is the biggest mistake sellers make. Says R. Layne Morrill, president of the National Association of Realtors (NAR): "People lose perspective when dealing with what is both a home and

fore selecting a real estate agent, we should have gone to open houses in our community of West Windsor, N.J., and in nearby towns. We could have seen what features other houses offered and at what price.

Such an exercise would have given us evidence of what our house was worth and how to price it to sell in a moderate amount of time.

Because we didn't do any research, we had no idea what to expect when we first sat down with Anne Borella, our real estate agent. A few days earlier, she had looked around our property and returned with a listing of comparable sites for sale, pointing out advantages and shortcomings of each. It was our fault that we didn't fully realize we lacked many of the features of better houses, such as a two-car garage or professionally landscaped yards. I just listened for the asking price and how long each home had been on the market.

Unfortunately for us, West Windsor is a "growing community," meaning that local farmland is being plowed under for housing developments: Many homebuyers are attracted to these houses newer than ours—and to the reputable school system and the location midway between New York and Philadelphia. And in keeping with the cookie-cut-

ter quality of West Windsor, almost everyone is looking for the same house: a relatively new four-bedroom, two-bath colonial in a development. Our house has four bedrooms, two baths, but is a 33-year-old split-level. Two strikes against us: an in-ground swimming pool (many people don't want the hassle of maintaining one, and families with small children don't want the danger), plus a four-lane road behind our property. Even Borella said, "I think you can reasonably start

asking at \$258,000."

REAL ESTATE

Imagine dollars piled up in my mailbox. Considering that Kevin and I had bought the house for \$175,000 in 1992, Borella's suggestion meant that even after her commission, we would realize an annual appreciation of 6.7%. That's a pretty high gain when compared with nationwide appreciation of only 3.4%. I was skeptical. Kevin was more skeptical. "No way this house goes for that price," he muttered. Borella left. But we decided to follow her lead, signing with her agency for the typical exclusive period of six months.

NO RUSH. That was another error. Because time was a factor for us, we should have asked for a shorter commitment period. In the first few weeks, the only brokers who came by seemed to be from her agency. After a week or so, Borella reported to us that the consensus was that the price was too high, but she suggested we stay with it a while to test the market.

In hindsight, of course, that was the wrong decision. Within only a few house-hunting seasons, usually hot selling seasons late April and May, we should have recognized our price was too high. After almost six weeks, Borella hinted we should cut the price. She

When the 'For Sale' Sign Goes Up

- ▶ Price it realistically by checking out similar houses nearby
- ▶ If your broker uses Web listings, make sure yours is posted quickly and kept current
- ▶ Paint inside and out where needed, as well as garage, outbuildings, and fence
- ▶ Trim the lawn
- ▶ Seal gutters and clean downspouts
- ▶ Clean windows, screens, and storm windows
- ▶ Fix all broken items, including leaky faucets, creaky doors, and loose cabinet knobs
- ▶ Get rid of all that junk in your closets and garage

DATA: NATIONAL ASSOCIATION OF REALTORS, BUSINESS WEEK

an investment," he says. As a result, he says, people think their house is worth more than anyone is willing to pay for it.

Kevin and I also failed to size up our competition. Be-

ASKING TOO MUCH Pricing is the biggest mistake sellers make



For Sale

DEEP WATER: *Madigan*
her husband found that
ol can be a drawback

ted out some of the
e's drawbacks. There
a lot more than when
irst chatted, leading to
revelation: We should
updated or corrected
ems we considered unim-
ant. "In retrospect, we
ed at \$258,000 too long,"

Borella. "But it was an
ecedented hot market."
concedes that the pool
the highway were bigger
offs than she had antici-
d. Before listing our
e, we had already done
7 of the tips suggested by
VAR (table). We touched
aint and discarded junk
e garage and closets. But

even after we cut our asking
price by \$20,000, to \$239,000,
we felt we needed to install
new carpeting in the foyer
and family room. Then the air-
conditioning unit died, and we
replaced that. The phrase "you
have to spend money to make
money" kept rolling through
my mind as I wrote out check
after check. Then again, the
NAR's Morrill compares selling
your house to getting married:
"You want to look the most
beautiful on your wedding day,
and you want your house to
look the most beautiful when
buyers come to look at it."

LONG WAIT. With traffic still
sparse and my commute get-
ting no easier, we waited only
a few weeks before we cut
the price again, in late June,
to \$229,000. Each price cut

brought a spurt of traffic, but
no offers. As an economist, I
could appreciate the process
of the market trying to find
the optimal price. As a seller,
I found the wait very frus-
trating. Especially when Kevin
and I realized that it was
wrong to expect that the
agent would take care of what
seemed obvious. In May,
Kevin logged on to the
agency's Web site to look for
our house, only to find it
wasn't listed. I called Borella,
who replied: "I put you on a
Web site called Realtor.com.
Do you want to be on our
Web site as well?"

"Well, duh," I wanted to an-
swer. The key to selling any
product is publicizing it wher-
ever possible. Borella said lat-
er that the bigger exposure

of Realtor.com made her feel
that a listing on her agency's
site was unnecessary. She said
she would take care of it, but
it took a further two weeks
and another telephone call be-
fore our house was up on the
agency's site.

Clearly, the Internet has
changed the way houses are
bought and sold (page 114).
The NAR's Realtor.com site,
which features houses already
listed with its member agen-
cies, allows house hunters to
peruse listings without the
hassle of going to a real estate
agent or an open house. "The
Internet gives us one of the
greatest tools to make infor-
mation available," says Mor-
rill. Kevin and I had not
wanted to go to the trouble of
selling on our own, but for

stock carefully what similar houses nearby are fetching

those homeowners who do, Abele Owner's Network maintains a site where, for a fee, photos and particulars of your house can be listed. Selling on your own takes more effort, but of course, you avoid the typical 6% sales commission.

Still without a nibble by late July, we cut the price again, to \$219,000. Too bad the agency's Web site didn't reflect that. In early August, our house was still listed at the original price. Once again, I

had to call Borella for the change to be made. Meanwhile, our neighbors, who had a vested interest in our house selling for the highest price, kept asking about our progress and making suggestions. "You did bury the St. Joseph's statue?" asked one neighbor at a Sunday night barbecue. To speed the sale of a house, some people bury a statue of St. Joseph upside down in the front yard. Why St. Joseph? He's the patron saint of car-

penters and builders. Why head down? Who knows?

I was not about to question a religious belief, however—especially one that might help us sell our house. The next day at lunchtime, I walked over to the gift shop at St. Patrick's Cathedral. The shop offered two statues: a \$7.95 four-inch version, and a larger one at \$29.95. Does size matter in this case? I bought the smaller statue, and Kevin buried it that evening.

Looking back, Kevin and I agree that if we had known in May what we know now we could have avoided so many hassles and wasted less time. After the last price drop, the offer was picked up, suggesting we were in the right ballpark. So I may wait to make another offer. But I've decided that if I don't have a contract by September, I'm going back to St. Patrick's and shelling out 30 bucks for the bigger statue. *Kathleen Madigan*

THE HOUSE OF YOUR DREAMS—PIXEL BY PIXEL

Maurice Velasquez wanted to buy a house with a fenced backyard but didn't want to "drag the kids all over town" looking at real estate. So "I got on the Internet," says Velasquez, president of Computer Software Academy, a high-tech training company in Baton Rouge, La. In three hours, he and his wife had identified 150 houses that met their criteria. The couple narrowed the choices to five and packed the kids in the car. "We fell in love with one of them as soon as we saw it, called the real estate agent, and made a successful offer the next day."

It makes sense to scout for houses through the Web. Online, you can browse through listings without an agent at your side. And almost every site has a financial section, where you can do everything from figuring out monthly mortgage payments to getting advance approval of a loan.

ZEROING IN. A few sites are standouts. RealSelect's Realtor.com, maintained in cooperation with the National Association of Realtors, catalogs more than 1.2 million properties, representing 63% of what's found in multiple listing services (MLS), the regional data banks of offerings from many agents. To find a house, indicate your preferred location, price range, and number of

bedrooms and bathrooms. You can narrow your search further by clicking on such prerequisites as a corner lot or hot tub. The site then displays houses that meet your specifications. Most listings are accompanied by a brief description and a picture of the exterior. You can also request a map that shows the property's location. For the ad-

landmarks, such as a post office or police station. You can even create custom maps that show how far a property is from your job or your child's day-care center. HomeAdvisor also offers statistics about the surroundings, such as the neighbors' median age and income. You can even get ratings of the local schools and the incidence of crime.

Since Realtor.com and HomeAdvisor don't offer comprehensive listings, you should also pay a visit to Web sites of agencies that specialize in the area where you are looking. International Real Estate Digest's site provides links to local brokers' home pages. In addition, take a gander at HomeHunter.com. Operated by publisher Knight-Ridder, it provides access to the real estate classified ads in 31 daily papers. To check out the for-sale-by-owner market, go to Abele Owner's Network, which has about 35,000 listings, as well as basic search and mapping functions. When you think you have a house tracked down your dream house, go to Experian Information Solutions' site.

There, you can find out the property's assessed valuation (\$7.95 for an E-mail report) along with the prices of five similar houses within a one-mile radius (\$9.95). Armed with this and other real estate information on the Internet, you'll be ready to make your move. *Kate Murry*

Finding a Home Online

WEB SITE

ABELE OWNER'S NETWORK
www.owners.com

COLDWELL BANKER ONLINE
www.coldwellbanker.com

EXPERIAN INFORMATION SOLUTIONS
www.experian.com

INT'L REAL ESTATE DIGEST
www.ired.com

HOMEHUNTER
www.homehunter.com

HOMEADVISOR
homeadvisor.msn.com

REALTOR.COM
www.realtor.com

DESCRIPTION

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Rates broker Web sites

Links to real estate classifieds in 31 daily Knight-Ridder newspapers

Microsoft's database of 500,000 homes, with excellent mapping

Lists 1.2 million homes, with good search and mapping tools

dress, you'll have to call the listing agent.

Microsoft's HomeAdvisor.com has only half as many MLS listings as Realtor.com but offers more bells and whistles. Its mapping function places houses in relation to nearby

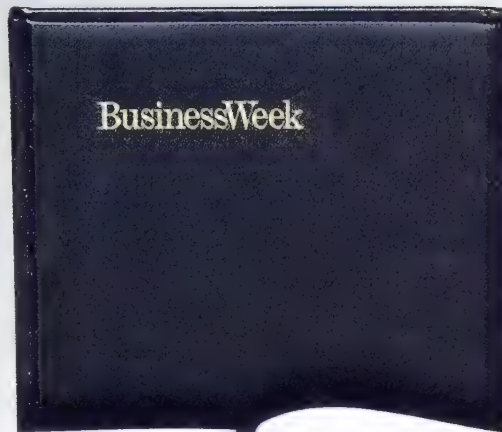
property's assessed valuation (\$7.95 for an E-mail report) along with the prices of five similar houses within a one-mile radius (\$9.95). Armed with this and other real estate information on the Internet, you'll be ready to make your move. *Kate Murry*

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Burgundy Desk & Pocket Planner Set	BW226	US\$48.95	US\$39.00		
Burgundy Desk Planner	BW216	US\$34.95	US\$27.95		
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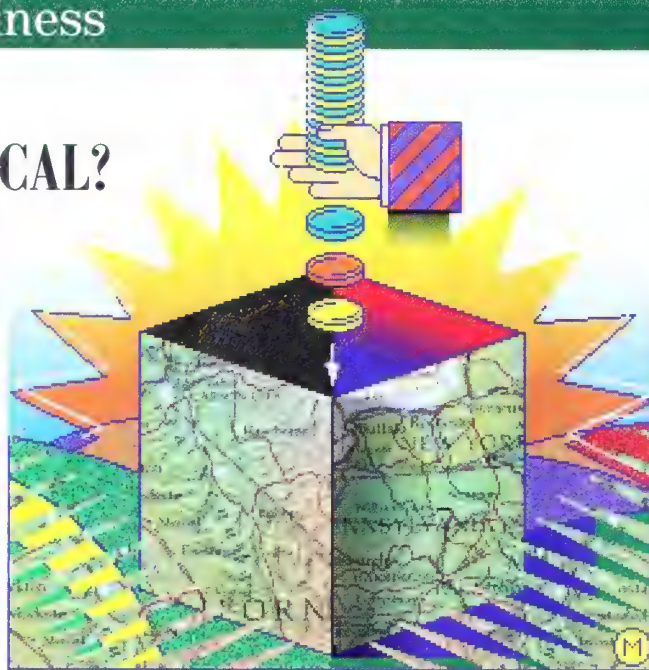
THINKING LOCAL? THINK AGAIN

When you consider mutual funds that specialize in a region, Asia or Europe come to mind—not the Carolinas or Mississippi. But what if you want to invest in your own state or in some particular U.S. region where the economy is especially robust? No problem: You now have the option of choosing from a sizable array of funds that look for hidden value in individual states and regions (table). Standard & Poor's Micropal (like *BUSINESS WEEK*, a unit of The McGraw-Hill Companies) tracks 26 such funds.

But if you're thinking of investing on the home front, tread carefully: Many of the funds are small, with less than \$100 million in assets, and few of them have been around long enough to establish long-term records. And over the past year, their performance hasn't exactly sparked. Of the five regional funds that specialize in small-capitalization stocks, for instance, all lost money this year. The small-cap regional funds' average decline of 9.2% through Aug. 20 was a good deal worse than the 7.7% decline posted by the Russell 2000 index during the same period.

CHOPPY WATERS. Regional funds that primarily target mid- and large-cap companies fared even worse: The mean return of the 21 funds in

that group was a loss of 3%, compared with a gain of 13.4% for the Standard & Poor's 500-stock index. But most regional funds have been hardest hit since the first quarter, reflecting the tough market climate for small- and mid-cap issues.



How Regional Funds Are Faring

Funds focusing on mid- and large-cap stocks

	ASSETS MILLIONS	TOTAL RETURN*	
		YEAR TO DATE	12 MONTHS
LEADERS			
REGIONAL OPPORTUNITY: OHIO-IND.-KY. B	\$6.4	20.1%	22.4%
CHASE VISTA GROWTH OF WASH. A	71.8	7.2	21.1
SIT REGIONAL GROWTH (CINCINNATI REGION)	5.1	6.0	NA
LAGGARDS			
MISSISSIPPI OPPORTUNITY A	\$4.3	-11.2%	-0.9%
AMSOUTH MUTUAL REGIONAL EQUITY	94.9	-9.9	NA
SEXTANT GROWTH (MIDWEST)	2.0	-9.4	-12.1

*Through Aug. 20

DATA: STANDARD & POOR'S MICROPAL

Says S&P Micropal Senior Fund Analyst David Masters: "The first question is, 'What can these funds offer me that I can't get elsewhere?'" Well, maybe not much. Masters notes that regional funds have tended to underweight the stocks of technology and financial-services companies, which have been growth engines. In addition, these local funds can get whacked if their regions' economies slow abruptly.

Still, some funds may be worth a look. Laura Lallo, a senior analyst at Morningstar, likes Franklin CA Growth I, which specializes in California companies. One of the larger regional funds, with about \$705 million in as-

sets, it has a three-year average annualized return of 17.2%. Reflecting California's vibrant technology sector, the fund has among its top holdings Cisco Systems, whose stock has more than doubled

since late 1997, and Compu Sciences, which has gone some 50% since yearend 1997. Despite these investments, the fund is down nearly 10% this year as other holdings including BankAmerica, Motorola, and Chevron, have choppy water.

HOME TRUTH. Sun Belt might check out Morgan Keegan Southern Capital in Memphis. Although it has managed only a 1% year-to-date return, it's still up 8% over the past 12 months and 20.1% annually for the past three years. With \$90 million in assets, the fund targets companies including WorldCom, the Jackson (Miss.) telecom giant, and retail stores including Proffitt's in Birmingham, Ala.—whose shares have taken a hit lately—Atlanta's Home Depot. Nonetheless, portfolio manager Elkan Scheidt notes that the South offers strong companies—and who better to know them than a guy who spent his time focused on his back yard?

That's the pitch with funds that follow the companies that you might read about in your local paper every day: "investing in what you know better than the guys in New York because you're closer there," says Lallo of Morningstar. But so far, she says, "I don't think any of the funds have overwhelmed investors." For the part, investing state-by-state isn't as safe a bet as tried-and-true method of assembling a more diversified portfolio. *Lawrence St...*

WORTH NOTING

■ Venture-capital-fund investors got a break from the Internal Revenue Service restructuring bill recently signed into law. The measure extends a 1997 exemption for stockholders of "qualified small businesses" (QSBs) with assets of \$50 million or less. That measure allows individuals with QSB stock to sell shares and reinvest the proceeds in another QSB issue without paying taxes—within 60 days. Now, mutual funds, partnership trusts, and other noncorporate taxpayers get the same treatment. The definition of a QSB is based on law depreciation standards. But QSB shares must have been issued in an initial public offering or private placement or as option rewards.

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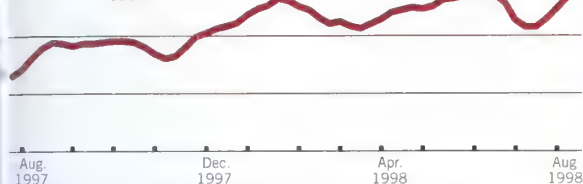
Business Week Index

PRODUCTION INDEX

Change from last week: 0.6%
Change from last year: 3.9%

PRODUCTION INDEX

Aug. 15=134.1
1992=100



The production index was up for the fourth week in a row in the week ended Aug. 15. The unaveraged index also increased, by 0.7%, from 134.5 in the previous week to 135.5. After seasonal adjustment, rail-freight traffic was up 1.7%, with increases in carloads of motor vehicles and equipment, waste and scrap metal, and food products. Output of steel, autos, electricity, oil, and coal were up. Truck production was down by 3.9%, and lumber output fell 1.7%.

Source: Index compiled by The McGraw-Hill Companies

LEADING INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STOCK PRICES (8/21) S&P 500	1081.18	1062.75	17.1
CORPORATE BOND YIELD, Aaa (8/21)	6.50%	6.52%	-11.2
VEHICLE SUPPLY, M2 (8/10) billions	\$4,229.0	\$4,222.3r	7.3
UNEMPLOYMENT CLAIMS (8/14) thous	301	303r	-11.2
PERMIT APPLICATIONS, PURCHASE (8/21)	243.1	251.4	10.6
PERMIT APPLICATIONS, REFINANCE (8/21)	1,211.9	1,310.5	119.2

Notes: Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Bankers Assn. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
FEDERAL FUNDS (8/25)	5.50%	5.54%	5.62%
COMMERCIAL PAPER (8/25) 3-month	5.49	5.50	5.55
CERTIFICATES OF DEPOSIT (8/26) 3-month	5.57	5.58	5.59
FIXED RATE MORTGAGE (8/21) 30-year	7.02	7.03	7.60
ADJUSTABLE RATE MORTGAGE (8/21) one-year	5.75	5.81	5.69
LIBOR (8/26)	8.50	8.50	8.50

Source: Federal Reserve, HSH Associates, Bloomberg Financial Markets

Notes: data in the production indicators are seasonally adjusted in computing the BW index (chart); other components (estimated and not listed) include machinery and defense equipment. 1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

THE WEEK AHEAD

HOME SALES

Monday, Aug. 31, 10 a.m. EDT ▶ New single-family homes probably sold at an annual rate of 1,000 in July, says the median forecast of economists surveyed by Standard & Poor's unit of The McGraw-Hill Companies. Sales are sold at a record high pace of 100 in June.

SURVEY

Monday, Sept. 1, 10 a.m. EDT ▶ The National Association of Purchasing Management's composite index probably edged up to 50.2% in August, from 49.1% in July. The end of the strike at General Motors Corp. pushed the index above the 50% mark that separates expansion from contraction in the factory sector.

However, the Asian-led drag in exports is hurting industrial activity outside of the auto sector.

LEADING INDICATORS

Tuesday, Sept. 1, 10 a.m. EDT ▶ The Conference Board's composite index of leading indicators probably rose 0.2% in July, reversing its 0.2% slide in June.

CONSTRUCTION SPENDING

Tuesday, Sept. 1, 10 a.m. EDT ▶ The S&P MMS survey forecasts that a 0.7% advance in building outlays occurred in July, on top of a 1.7% surge in June. The July gain is suggested by the large 5.7% increase in housing starts in July.

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (8/22) thous. of net tons	2,127	2,120#	4.9
AUTOS (8/22) units	119,739	126,473r#	-1.0
TRUCKS (8/22) units	136,475	127,876r#	14.2
ELECTRIC POWER (8/22) millions of kilowatt-hrs.	76,283	77,764#	4.8
CRUDE-OIL REFINING (8/22) thous. of bbl./day	15,577	15,615#	1.8
COAL (8/15) thous. of net tons	21,840#	21,243	4.7
LUMBER (8/15) millions of ft.	489.7#	494.7	1.9
RAIL FREIGHT (8/15) billions of ton-miles	26.9#	26.2	3.5

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WWPAl, SFPAl, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (8/26) \$/troy oz.	283.150	285.500	-12.8
STEEL SCRAP (8/25) #1 heavy, \$/ton	120.50	120.50	-17.7
COPPER (8/21) ¢/lb.	77.0	76.2	-24.2
ALUMINUM (8/21) ¢/lb.	63.8	63.5	-22.2
COTTON (8/22) strict low middling 1-1/16 in., ¢/lb.	73.19	71.40	2.7
OIL (8/25) \$/bbl.	13.81	12.81	-27.3
CRB FOODSTUFFS (8/25) 1967=100	220.77	225.62	3.0
CRB RAW INDUSTRIALS (8/25) 1967=100	287.47	289.29	-15.2

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (8/26)	144.53	144.31	119.06
GERMAN MARK (8/26)	1.81	1.80	1.81
BRITISH POUND (8/26)	1.64	1.62	1.61
FRENCH FRANC (8/26)	6.06	6.03	6.09
ITALIAN LIRA (8/26)	1782.5	1773.1	1767.0
CANADIAN DOLLAR (8/26)	1.56	1.53	1.39
MEXICAN PESO (8/26)	9.810	9.192	7.753
TRADE-WEIGHTED DOLLAR INDEX (8/26)	116.9	115.9	106.6

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan

FACTORY INVENTORIES

Wednesday, Sept. 2, 10 a.m. EDT ▶ Manufacturers likely decreased their inventories by at least 0.3% in July, after stock levels rose 0.2% in both May and June. The GM strike was responsible for a large part of the inventory drawdown.

EMPLOYMENT

Friday, Sept. 4, 8:30 a.m. EDT ▶ Nonfarm payrolls likely soared by 350,000 in August, says the MMS forecast. About 140,000 of the gain reflects workers at GM and its suppliers heading back to work after the strike. The strike held job growth in July to just a 66,000 increase. The unemployment rate is expected to have stayed at 4.5% in August.

This Week, Online

Business Week presents frequent live conferences and chats on America Online—your opportunity to ask questions about timely topics.

ONLINE
BusinessWeek

Sunday

How to handle sexual harassment in the workplace: Attorney William Bruce answers your questions in another BW Enterprise chat.
Aug. 30
9 p.m. EDT

Tuesday

Wait for the market to close and then tune in to Standard & Poor's analyst Brendan McGovern on semiconductor stocks. S&P Personal Wealth is co-host with BW. **Sept. 1**
4:30 p.m. EDT

Thursday

Need help picking the right mutual fund? Join BW's fund guru, Jeffrey M. Laderman, for some expert pointers.
Sept. 3
9 p.m. EDT

AOL keyword: BW Talk

Transcripts of all conferences are available for downloading from the BW Online area on AOL soon after each event.

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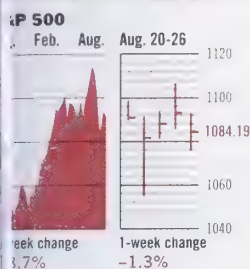
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Investment Figures of the Week

STOCKS



IMMENTARY

Russian financial crisis shock waves throughout world, including the U.S. financial markets. Banks as J.P. Morgan and Citi were among the biggest rs because of concerns they may suffer losses Russian and other emerg-market debt. The Dow's industrial average fell points during the day on 26, but recovered to end day at 8523.4, down 79. ts of 30-year U.S. bonds lined to their lowest levels e 1977 as investors ed to safety.

U.S. MARKETS

	Latest	% change Week	Year
Dow Jones Industrials	8523.4	-2.0	9.5
NASDAQ Combined Composite	1768.1	-4.0	10.8
S&P MidCap 400	318.8	-5.1	1.5
S&P SmallCap 600	160.5	-6.1	-7.9
S&P SuperComposite 1500	228.0	-1.8	15.8

SECTORS

	Latest	% change Week	Year
Bloomberg Information Age	358.4	-1.5	22.5
S&P Financials	121.6	-4.6	16.3
S&P Utilities	240.3	1.6	20.9
PSE Technology	335.4	-4.1	1.8

FOREIGN MARKETS

	Latest	% change Week	Year
London (FT-SE 100)	5545.4	-2.6	13.0
Frankfurt (DAX)	5231.6	-6.5	30.9
Tokyo (NIKKEI 225)	14,866.0	-3.5	-19.4
Hong Kong (Hang Seng)	7834.4	2.8	-49.6
Toronto (TSE 300)	6172.3	-5.2	-7.5
Mexico City (IPC)	3254.4	-9.7	-33.8

FUNDAMENTALS

	Latest	Week ago	Year ago
S&P 500 Dividend Yield	1.44%	1.43%	1.65%
S&P 500 P/E Ratio (Last 12 mos.)	26.4	26.2	23.0
S&P 500 P/E Ratio (Next 12 mos.)*	24.4	24.4	18.3
First Call Earnings Revision*	-3.26%	-3.33%	-1.06%

TECHNICAL INDICATORS

	Latest	Week ago	Reading
S&P 500 200-day average	1057.3	1053.5	Positive
Stocks above 200-day average	26.0%	30.0%	Positive
Options: Put/call ratio	0.66	0.66	Neutral
Insiders: Vickers Sell/buy ratio	1.09	1.16	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

BEST-PERFORMING GROUPS

	Last month%	Last 12 months%
Drug Chains	8.7	Specialty Appar. Retailers 78.5
Computer Systems	7.0	Drug Chains 72.7
Tobacco	6.0	Broadcasting 72.5
Food Chains	5.7	Drugs 67.1
Genl. Merchandise Chains	5.5	Genl. Merchandise Chains 65.2

WORST-PERFORMING GROUPS

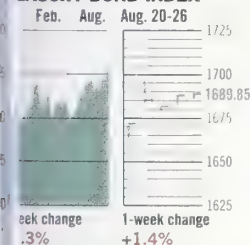
	Last month%	Last 12 months%
HMOs	-41.9	Oil & Gas Drilling -57.0
Savings & Loans	-22.2	Metals -54.2
Metals	-19.3	Gold Mining -42.9
Shoes	-19.2	Leisure Time -40.0
Leisure Time	-18.9	Engineering & Constr. -37.8

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness	Price	1-month change
Intel	84 ²⁷ / ₆₄	-1 ⁴¹ / ₆₄
Citicorp	136 ⁷ / ₈	-31 ¹ / ₂
America Online	110 ³ / ₄	-6 ³ / ₄
Merrill Lynch	86 ⁹ / ₁₆	-12 ¹ / ₁₆
General Electric	90 ⁹ / ₁₆	-1 ¹ / ₁₆
Lucent Technologies	87	-7 ³ / ₈
Decline ahead? Stocks with most significant selling on price strength	Price	1-month change
Cisco Systems	103 ¹⁵ / ₁₆	6 ⁷ / ₁₆
Dell Computer	124	13 ³ / ₄
Yahoo	97 ¹ / ₂	2 ²⁹ / ₃₂
American Home Products	58	5 ³ / ₄
Home Depot	45 ⁷ / ₈	1 ¹ / ₂
Mobil	72 ⁷ / ₈	1 ⁹ / ₁₆

INTEREST RATES

TEASURY BOND INDEX



Bloomberg Financial Markets

KEY RATES

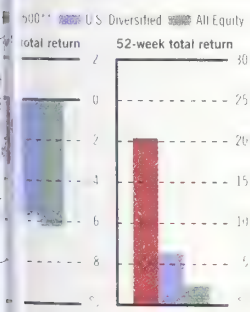
	Latest week%	Week ago%	Year ago%
MONEY MARKET FUNDS	5.10	5.11	5.15
90-DAY TREASURY BILLS	5.05	5.07	5.28
6-MONTH BANK CDS	5.06	5.07	5.17
1-YEAR TREASURY BILLS	5.09	5.25	5.60
10-YEAR TREASURY NOTES	5.20	5.42	6.38
30-YEAR TREASURY BONDS	5.42	5.56	6.66
LONG-TERM AA INDUSTRIALS	6.21	6.27	7.15
LONG-TERM BBB INDUSTRIALS	6.69	6.81	7.53
LONG-TERM AA TELEPHONES	6.55	6.61	7.46

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond Latest week	10-yr. bond Last week	30-yr. bond Latest week	30-yr. bond Last week
GENERAL OBLIGATIONS	4.27%	4.38%	4.86%	4.93%
PERCENT OF TREASURIES	82.12	81.01	89.66	88.73
TAXABLE EQUIVALENT	6.19	6.35	7.04	7.14
INSURED REVENUE BONDS	4.44	4.53	5.06	5.15
PERCENT OF TREASURIES	85.39	83.78	93.35	92.69
TAXABLE EQUIVALENT	6.43	6.57	7.33	7.46X

MUTUAL FUNDS



EQUITY FUNDS

Leaders	Laggards
Four-week total return %	Four-week total return %
Anchor Capital Accumulation 53.1	Lexington Troika Russia -49.4
Prudent Bear 7.4	Excelsior Latin America A -29.3
Profunds UltraBear Investor 6.0	Govett Latin America A -29.2
Fidelity Select Computers 4.3	AIM Latin American Grth. B -28.3
Comstock Part. Cap. Val. R 3.8	ABN AMRO Lat. Amer. Com. -28.0
Leaders	Laggards
52-week total return %	52-week total return %
Anchor Capital Accumulation 73.7	Lexington Troika Russia -84.7
Weitz Hickory 51.3	Guinness Flgt. Asia Sm. Cap -72.2
Munder NetNet A 48.2	Lex. Crosby Sm. Cap Asia -70.7
Transamerica Prem. Sm. Co. 47.6	Montgomery Emerg. Asia R -69.6
Smith Barney Telecom. Inc. 47.0	U.S. Global Inv. China Reg. -69.0

EQUITY FUND CATEGORIES

Leaders	Laggards
Four-week total return %	Four-week total return %
Utilities -2.1	Latin America -25.8
Domestic Hybrid -2.6	Diversified Emerging Mkts. -18.8
Large-cap Growth -3.5	Precious Metals -12.4
Technology -3.6	Small-cap Blend -9.8
Health -3.7	Natural Resources -9.8
Leaders	Laggards
52-week total return %	52-week total return %
Communications 25.6	Pacific/Asia ex-Japan -55.9
Utilities 22.1	Precious Metals -45.2
Europe 20.3	Diversified Emerging Mkts. -43.3
Large-cap Growth 19.4	Diversified Pacific/Asia -42.8
Financial 16.5	Latin America -42.5

NEEDED: A NEW DEAL ON GLOBAL DEBT

Central bankers flocking to Jackson Hole, Wyo., for their annual late-August retreat this year might want to take time to learn the DIP. It's not a dance but rather something called debtor-in-possession financing. DIP involves segregating the defaulted loans of a bankrupt company, wiping the slate clean, and starting the borrowing process all over. A restructured company gets new credit, the bank gets a small percentage of its old unwise loans back over time, and everyone starts to play the all-important growth game again. DIP lending is a desperation strategy used only when corporations face ruin and banks stand to lose everything. This is increasingly the plight of Russia, Asia, and parts of Latin America, where *de facto* default may be the best choice among evils.

Debt overhang is crushing economic growth. It is time to consider a global write-down. The best way may be to swap emerging-market debt for long-term bonds backed by hard collateral ranging from U.S., German, and Japanese government bonds to Russian oil reserves. That was the idea behind the Brady bonds, named after Nicholas Brady, Treasury Secretary under George Bush, that helped revive economic growth in Latin America and Central Europe in the '80s. Then, government debt was swapped for the Brady bonds. Today, most of the debt is private, making the swap more complicated but not impossible. Brady-style bonds can work in the '90s, too.

The Russian crisis highlights the global liquidity squeeze that is strangling economic growth on a scale not seen for decades. In what were just a year ago some of the fastest-growing regions of the world, banks are not lending, governments are devaluing, and investors are racing to sell currencies and assets in one country to cover losses in another. An International Monetary Fund-sponsored policy of higher interest rates, higher taxes, and competitive devaluations is sending much of the global economy into a disastrous deflationary spiral. Ask any Kansas farmer or CEO of a multinational in Chicago. World demand for their products is plummeting, along with prices paid and profits made.

BANKS MUST BEGIN LENDING

A backlash against globalization has already begun. Without a dramatic policy change by international creditors, leadership in the current crisis will slip away from the dominant industrial countries and international lending agencies. Already, devastated Asians, angry at the damage done to them by high-octane global capital and inappropriate IMF policies, appear to be losing faith in the open-market system and the institutions that support it. Hong Kong, the paragon of *laissez-faire* capitalism, is openly intervening in the stock market. Thailand and Indonesia are nationalizing banks. Now, Russia is taking a giant step backward by contemplating capital and price controls while printing rubles.

The epicenter of pain is East Asia, where the spreading

crisis began a year ago. Output is collapsing, unemployment is soaring, and a nascent middle class—hitherto one of his country's champion consumers of goods and services—is being pushed back into poverty. This region alone constituted half all output growth from 1991 to 1997. Without this Asian demand, commodity prices are falling around the world, putting tremendous pressure on any nation that exports oil, grain, livestock, or gold. The Canadian dollar is down to a year low against the U. S. dollar; the South African rand is crumbling, the Venezuelan bolivar is set to tumble, and the ruble is in free fall.

The downward spiral won't end until demand is restored and deflation is stopped. To do this, banks must begin lending. American banks hold about \$40 billion of Asian debt. European banks hold the lion's share, about \$350 billion. In addition, Germany has up to \$30 billion of loans to Russia. The Japanese have \$245 billion in East and Southeast Asian debt on their books. All these banks already face significant write-offs on these loans ranging from 30% in Hong Kong to 80% in Indonesia and 90% in Russia. If the emerging world recession gets worse, the banks could wind up with nothing. Better to save something by taking a hit, exchanging bad debt for new long-term paper. Japan, in particular, can benefit from this plan. Only a dramatic write-down can get the country moving again and pull it out with it.

RETHINK IMF POLICY

An increase in global liquidity must accompany the new deal on debt. That demands a dramatic change in IMF policy. Devaluation, high interest rates, and high taxes have led to a restoration of investor confidence in Asia. They have not done so in Russia, either. Indeed, there is a revolt against IMF policies under way. Russia, Thailand, South Korea, and Indonesia are turning away from austerity and daring to stop them. Huge public-works programs are being launched in Asia to generate jobs, build needed infrastructure, and stimulate demand. Six months ago, the IMF demanded that Jakarta run a balanced budget. Now, Indonesia has decided to run a deficit of 8% of gross domestic product. Thailand has decided to run a 3% budget surplus in exchange for IMF support. Bangkok reversed course, and now it will run a deficit. Along with nearly all the other Asian countries in the region, Thailand is lowering interest rates significantly as well. Indeed, rates in Korea and Thailand are now half what they were six months ago.

It is time for a clean financial slate. New lending and debt easing are needed to get everyone back in the growth game. A swap of old debt for new bonds not only forces lenders to take a needed haircut, it also sets the stage for pumping liquidity again in the global economy. It sends the message the Jackson Hole central bankers should have sent away from their sojourn.

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BusinessWeek

SEPTEMBER 14, 1998

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president,
strategy



the GOP



g business?

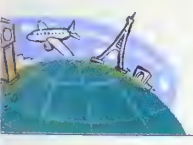
Microsoft



Steve
Ballmer,
Bill's
co-pilot

Travel

new lure
ties



GLOBAL CRISIS TIME TO ACT

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SEP 8 - 1998
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Plus

**GLOBAL INVESTING:
WHAT TO DO NOW**

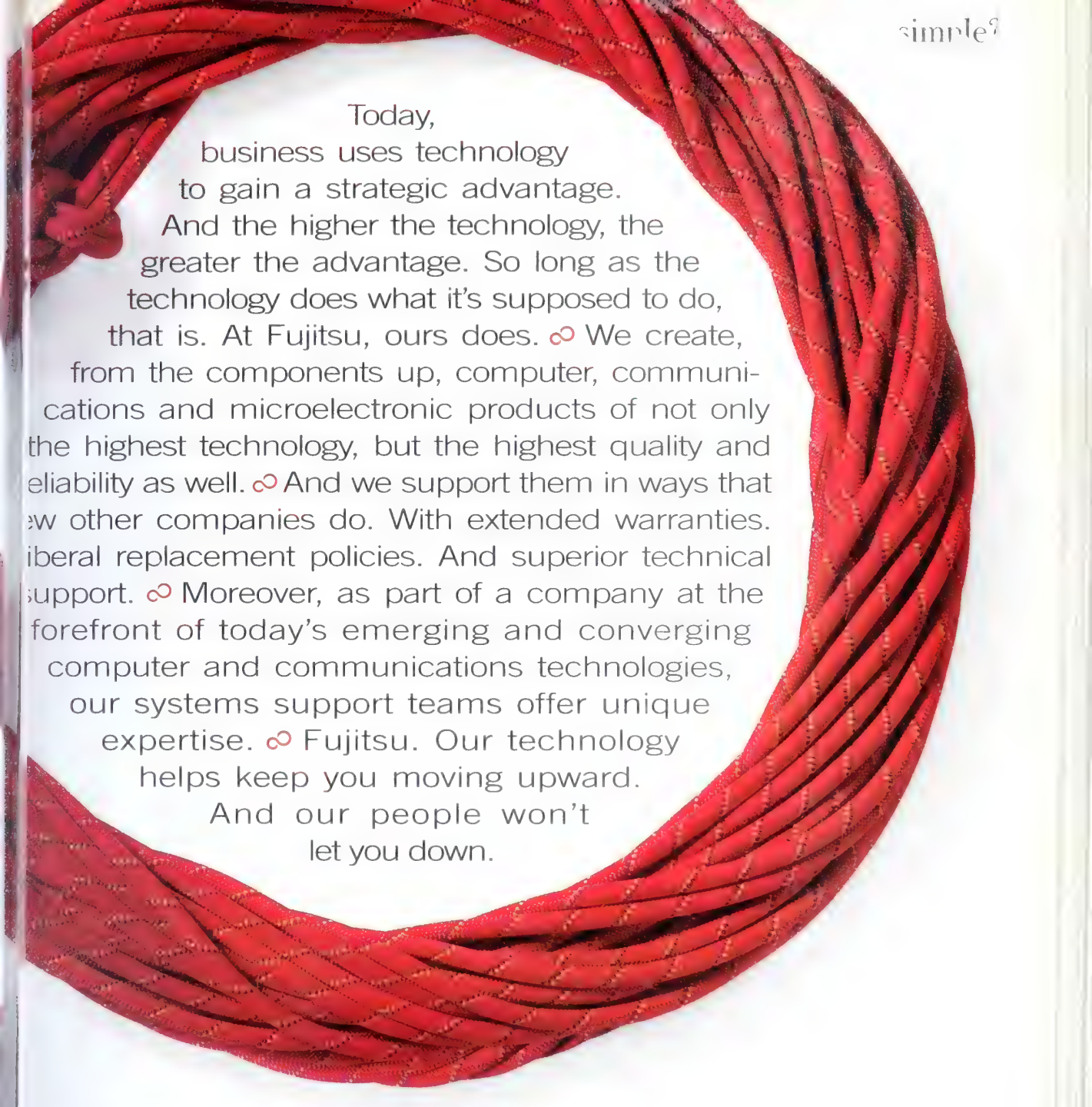
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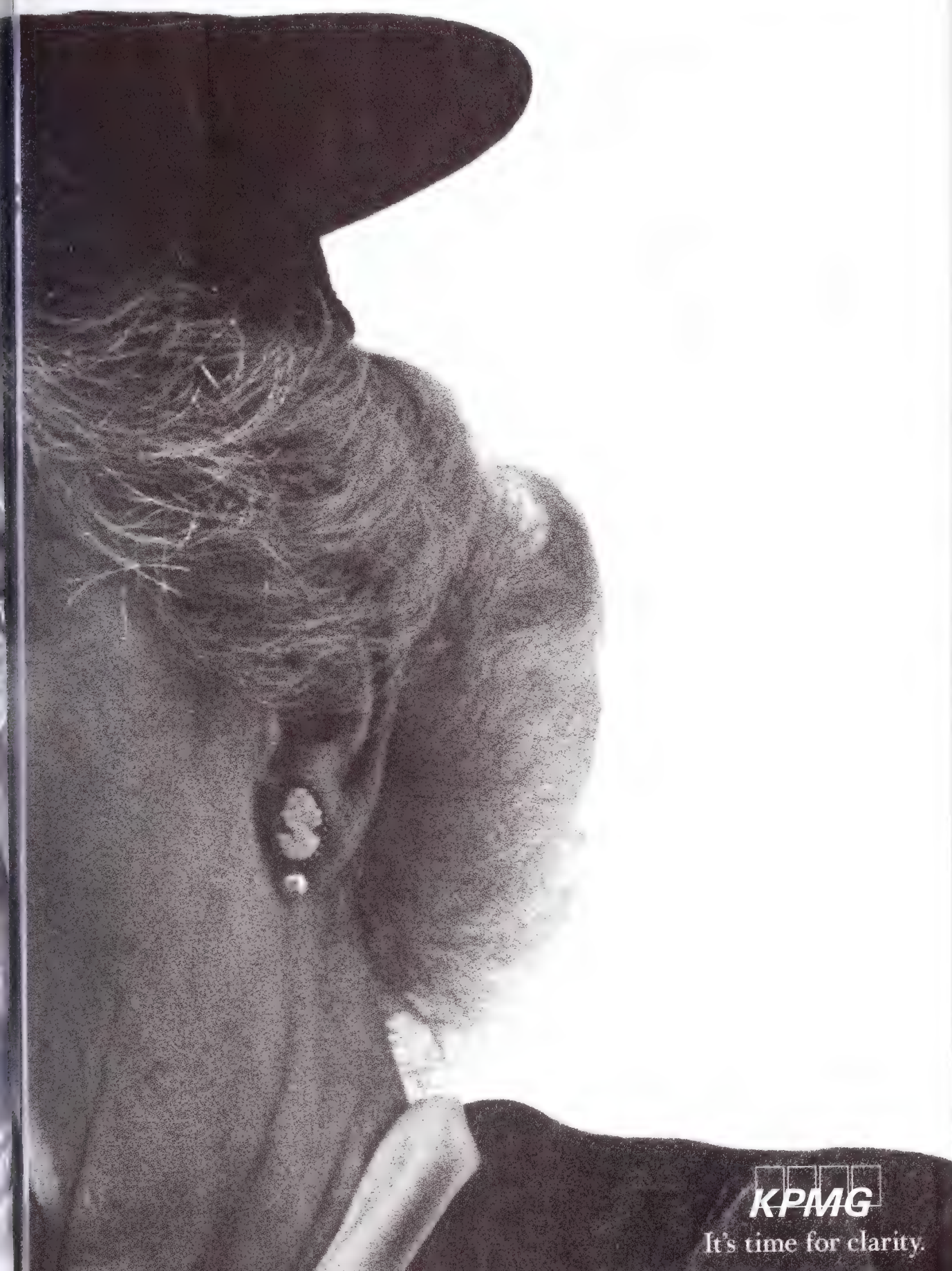
FUJITSU

COMPUTERS, COMMUNICATIONS, MICROELECTRONICS

er warned you, "Just because everyone else jumps off the Bro



de doesn't mean you should." Why can't consultants keep it that simple?



KPMG

It's time for clarity.

COVER STORY

TIME TO ACT A coordinated, U. S.-led move by the G-7 industrial nations to restore financial stability and confidence is the cautious approach. The real risk lies in doing nothing page 34



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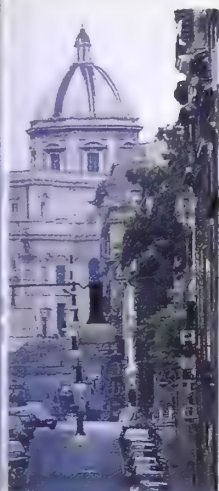
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What's the problem with a typical profit that focuses on where your bu



been? Well, for starters, you've already been there.



from when

APRIL

Up Front

TALK SHOW "An alternative hypothesis to 'the Internet makes you depressed' is that Pittsburgh makes you depressed. Both are equally valid."

—Vanderbilt University professor Donna Hoffman, objecting to a Carnegie Mellon study about the Internet

EDITED BY
ROBERT McNATT

I-WAY PATROL

PROGRAMMERS, DA!

YO, COMRADE! RUSSIA'S economy may be hitting the skids. But Moscow-based software house ArgusSoft wants to help us Americans with our software labor shortage by offering the services of 120 programmers back in the motherland—via the Internet.

Think of the many advantages of this plan. First, it will help ease the scarcity of programmers. Second, it circumvents the need to get around the 65,000 visa-per-year ceiling on H-1B visas granted to those with special skills. Third, it will get money into Russia. Soon.

As Peter Oykman, ArgusSoft's Frederick (Md.)-based rep, describes the problem: "If we had depended only on

[Russian government] budget money, we'd have been dead by now." The company has yet to be paid for work for Russian state ministries. However, ArgusSoft does collect paychecks from U.S. clients—although payment is in rubles. U.S. customers have included Olimplex International and Agilis Corp., both of Maryland.

Why not just come to America to work? ArgusSoft's own lawyers advised it to forget about it, noting the H-1B problem and the likelihood that programmers would leave ArgusSoft for greener pastures.

Joan Oleck



SILICON SAGAS

SO WHY ISN'T THIS MAC GOING TO MARKET

THE NEW 366 MEGAHERTZ G3 Macintosh minitower, made with a speedy Motorola 366 MHz chip, is Apple Computer's fastest PC yet. The high-end, \$3,000 computer should be a coup for Apple and its founder, Steve Jobs. The only problem: It has been yanked from production, with no explanation, after resellers sent out mailings about it and put it on catalog covers.

Announced on July 27, the PC was canceled by Apple on Aug. 14, says Mark Bradley, a senior vice-president at The Mac Zone, a cataloger that sent out 2 million mailings. Other resellers also got no-

tice of the withdrawal. nonexistent 366 is also on cover of the most recent MacMall catalog, among others. Apple gave no reason for its action, although G3s slower chips are available.

A Motorola spokesman says the 366 MHz: "the time you start a new product, the fastest speeds, the most difficult. It takes a while to ramp up production." He would



JOBS: Missing PC

not say whether enough 366 MHz chips were yet available.

So far, customers are having a hard time understanding, according to Dan DeVries, a sales executive at MacMall. But for how long?

Roy Fure

PRODUCT PEEK

THE NEW HAPPY PILL ON THE BLOCK

THE FIERCELY COMPETITIVE market for antidepressants in the U.S. is about to get a new entrant. Forest Laboratories is expected to launch Celexa in mid-September. And some analysts say the drug, which has been sold for years in Europe by its Danish developer, H. Lundbeck A/S, could be a big moneymaker.

Part of a class of antidepressants that includes Eli Lilly's Prozac and Pfizer's Zoloft, Celexa has certainly lifted spirits at Forest. Even after the recent market slide, Forest's stock has risen sharply in 1998. Cowen & Co. analyst Stephen Scala says that

by grabbing 10% of the market, Celexa should generate \$500 million in sales in the fiscal year ending March, 2002. Forest's total fiscal 1998 sales were \$427 million.

But rivals may make an issue out of 12 overdose deaths involving the Forest compound outside the U.S., says Scala. Forest officials and outside experts, including Scala, say there is no evidence that it is easier to overdose on Celexa than on similar antidepressants. And Celexa, says Forest, is also less likely to cause bad interactions with some other medications—an advantage for older patients.

Amy Barrett



THE LIST E-COMMERCE'S NEW 'NETIZENS'



To nobody's surprise, infotech companies such as Microsoft, IBM, Excite, and AT&T spend the most on Internet ads. But many traditional companies are starting to lay out big bucks to promote themselves online.



TOP TEN NON-TECH ADVERTISERS ON THE NET

COMPANY	1997 SPENDING MILLIONS	GROWTH SINCE 1995
1. GENERAL MOTORS	\$5.77	+390.0
2. CBS SPORTSLINE	5.71	+134.0
3. FORD MOTOR	4.92	+314.0
4. TOYOTA MOTOR SALES USA	4.00	+84.9
5. WALT DISNEY	3.50	+313.9
6. VISA INTERNATIONAL	3.37	+671.8
7. AMAZON.COM	3.16	+91.0
8. HONDA MOTOR CO.	2.86	+182.4
9. DONALDSON LUFKIN & JENRETTE	2.71	+356.9
10. CHARLES SCHWAB	2.69	+228.9

DATA: INTERMEDIA



I WATCH

RE'S SHRIMP THEM THAR HILLS

LAND OF BOURBON AND grass may soon be in for, of all things, its up. It seems that Ken-farmers, seeking alter-es to tobacco, have oped a fledgling shrimp try—where the little ers grow fat on byprod-of sour mash. t don't plan on shrimp quite yet. These Asian up taste more like lob-not bourbon, says James

IL TALES

EGEL'S ELEMENTS OF STYLE

SPIEGEL CATALOG THAT ionally heralds fall is—o be unkind—a gray clothes that are attrac-but hardly high chic.

meet her er little sis-On Sept. 8, gel mails not its "big book" also 2 million s of its new ents catalog. r a more so-cated look, this catalog uses sensual photos eek home fur-ings and luxe

ons. It's aimed at women 40 who wouldn't dream tting near, say, a messy t. Velvet boudoir pillows silk pajamas imply roic interludes, not chang-iaplers. "It really is a sophisticated aesthetic

that you would find at higher-price points, like a Donna Karan," says Lisa Versacio, elements' managing director.

John Irvin, president of Spiegel's catalog division, hopes such niche marketing (which includes a third catalog, On View, with a European flavor) will boost Spiegel's sagging sales.

But catalog consultant Maxwell Sroge is skeptical. "Spiegel has had a serious problem defining who they are in the marketplace," Sroge says. "They are moving into an area of mass confusion, trying to be three different women. They should stay with the girl that brought them to the party." Joan Oleck



SLEEK: elements

Tidwell, a Kentucky State University aquaculturist who is considered the father of the state's shrimp industry. He adds that the shrimp, grown in shallow ponds, flourish, thanks to Kentucky's climate and the waters from its limestone springs.

Kentucky shrimping began seven years ago when distillers asked Tidwell to find a use for sour mash waste. He came up with shrimp feed, now produced commercially by Farmer's Feed Mill in Lexington. Slowly, a handful of farmers began growing shrimp as a cash crop. In September they begin harvesting the state's 10,000-pound annual shrimp take, bound for export to Toronto.

Tidwell says that the shrimp farmers will soon decide whether to build a \$300,000 hatchery, a necessity if shrimping in Kentucky is to rival the state's shrinking \$1 billion a year tobacco industry.

James Ott

DRAWN & QUARTERED

BASEBALL HALL OF FAME

MARGULIES
Illustration by David Looney



CAR TALK

WHEELS OF FORTUNE?

MENTION THE ALFA ROMEO, and most car buffs think of Dustin Hoffman in *The Graduate*, shooting across the Bay Bridge to snatch sweetheart Katharine Ross from an unwanted marriage.

Now, the 1966-69 Alfa Romeo Duetto Spider is more than a movie memory. *Hemmings Motor News* has named it one of 1998's best entry-level collectible cars, says editor Dave Brownell. He pegs its popularity not to the movie but to the fact that the Duetto is a good drive, sharp-looking, and—here's what collectors love—undervalued.

Pre-World War II models

are too pricey for starting collectors. But a '69 Duetto in mint condition goes for only \$10,000. Most collectible cars go up in value from 5% to 10% annually. Brownell expects the Duetto, of which 6,300 were made, to appreciate at the 10% rate. "The Alfa is a wonderful driving

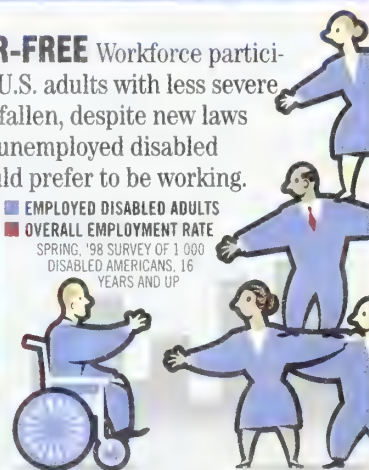
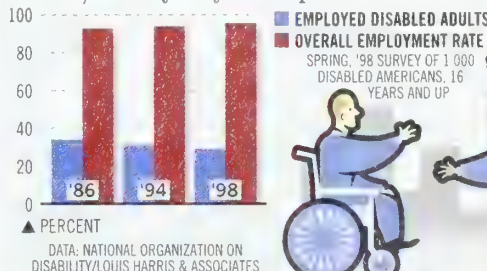


WATCH THE RUST: Alfa's Duetto

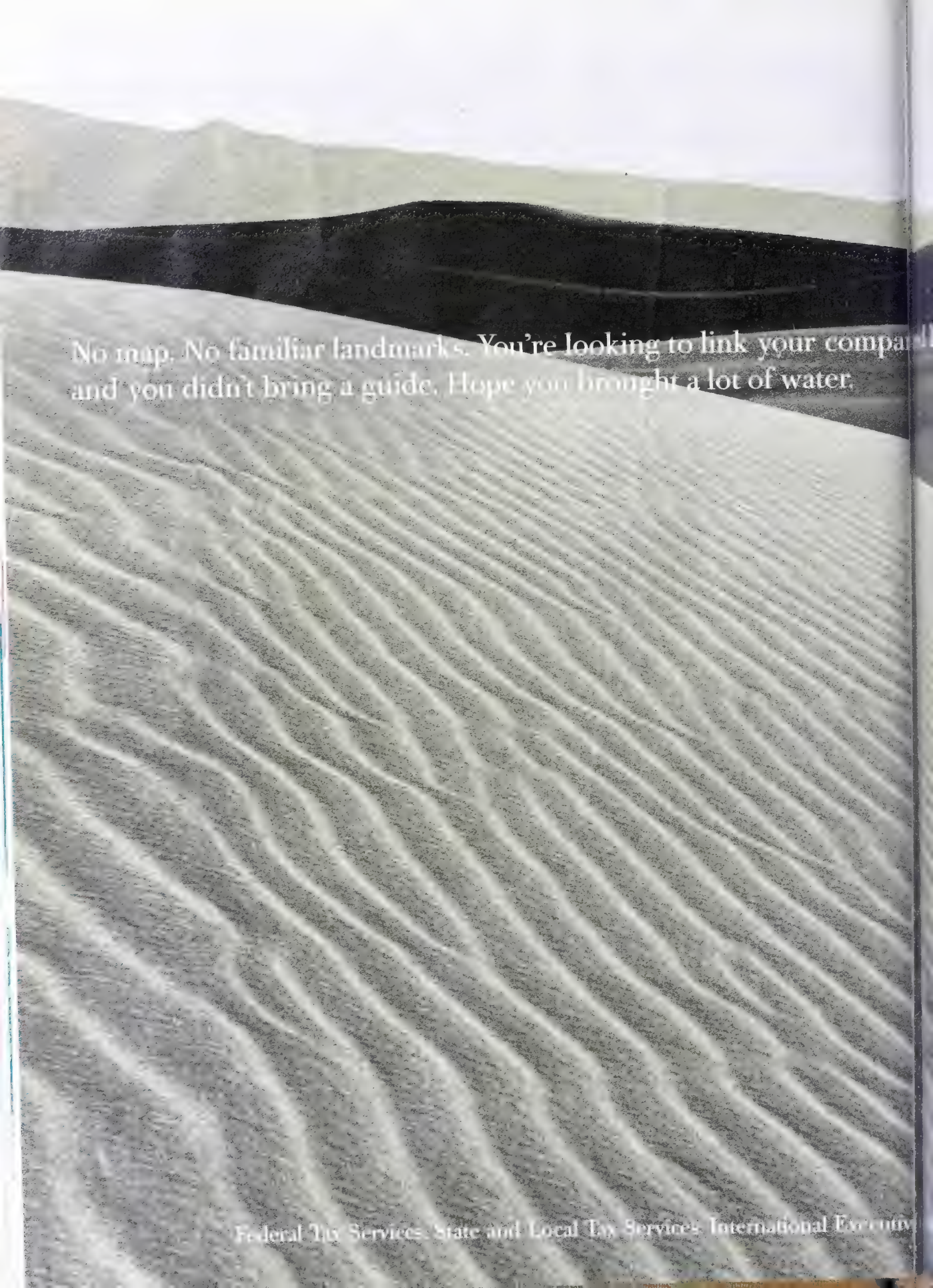
car with very balanced steering and the verve and spirit of a Ferrari," he says. He cautions that the cars are rust-prone and temperamental. But who cares when you can drive the car that made Dustin a star? Keith Felcyn

THE BIG PICTURE

STILL NOT BARRIER-FREE Workforce participation of the 17 million U.S. adults with less severe disabilities has actually fallen, despite new laws and other efforts. Of all unemployed disabled adults, 72% say they would prefer to be working.

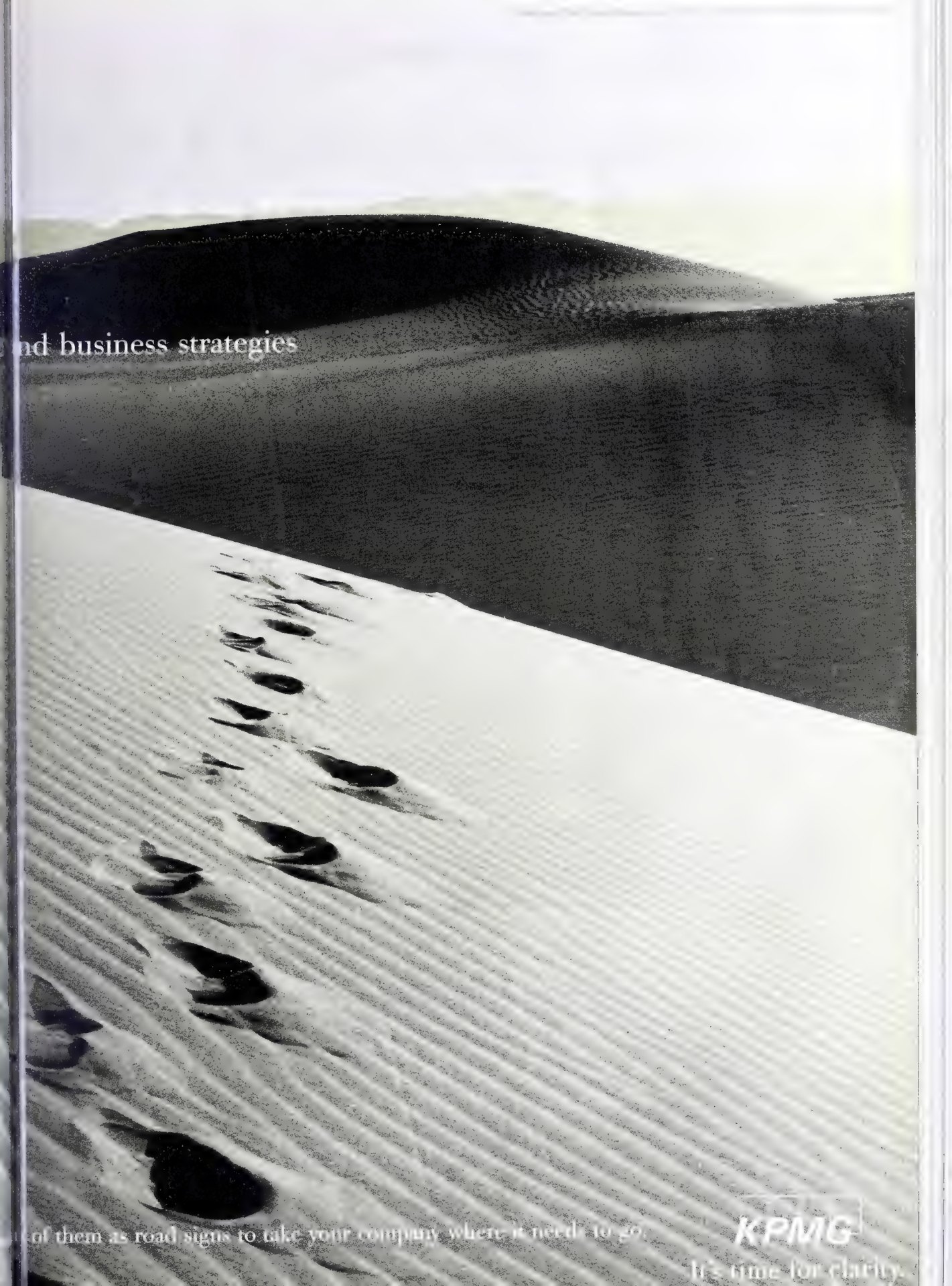


NOTES B-school deans who would admit the unqualified child of a rich donor: 48%, the child of a personal friend, 26%

A black and white photograph of a desert landscape. The foreground is dominated by a large sand dune with distinct, wavy ripples. In the background, there are dark, silhouetted mountains under a light sky. The overall mood is one of isolation and vastness.

No map. No familiar landmarks. You're looking to link your company
and you didn't bring a guide. Hope you brought a lot of water.

Federal Tax Services. State and Local Tax Services. International Executive



and business strategies

of them as road signs to take your company where it needs to go.

KPMG

It's time for clarity.

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INSIGHTS INTO THE 21ST CENTURY

I commend you on your informative articles addressing the opportunities and challenges of the "The 21st century economy" (Cover Story, Aug. 24-31). There are interesting parallels between events of the 1920s and what is happening in the semiconductor industry in the late 1990s. The automobile industry drove the financial engine in the first half of the 20th century. Now, the technology advances of the personal computer, networked computers, and the Internet are driving the economic engine of the second half of the century in the U.S.

The fact that during a financial crisis, pumping money into the system—rather than taking it out as the central bankers did in 1929—can avoid depression is something all financial planners worldwide need to comprehend. There will always be recessions, because that's part of the free-enterprise system, but learning from history can prevent the repeat of a major depression.

William I. Dollar
 Santa Cruz, Calif.



There is a simple reason—which everyone is overlooking—for why we have reached a "new economy." For 40-plus years, we have plugged our resources into the cold war. Not only did we plunge dollar after dollar into a useless cause (well, economically useless) with no return on investment, but we also occupied many of our valuable scientists. It's no coincidence that we've had a huge technological boom a few years after the end of the cold war. The 1990s are about transforming our military resources into capitalistic ones. Obviously, with less money spent on the military, we have had better productivity, income, and living standards.

Dan Oliver
 Irvine, Calif.

Sizable chunks of your special issue are off-base. The Pollyannaish gushing about the economic and social progress we will attain through biotechnology and globalization is premised on several things not going wrong—Asian meltdown and no stock market decline, to name a few you list in your bright box.

Funny thing is, the rest of the issue acknowledges that the global economy is in the throes of these very plagues, and the stories titled "There is no wishing [Asia] crisis away," "The markets: In a cry, it's only deflation," etc.

Plus, you announce that "the defining issues of the Industrial Age—the rise of trusts, the battle to end child labor, to codify workers' rights, the regular protections spawned by the consumer

PEACE DIVIDEND?

"It's no coincidence that we've had a huge technological boom a few years after the end of the cold war. The 1990s are about transforming our military resources

movement—have faded." Yet the globalization orchestrated through pacts such as NAFTA and the Multilateral Agreement on Investments and institutions such as the World Trade Organization, undermining these citizen safeguards. It is precisely the threat to technological achievements of the democratic process that has fueled the worldwide backlash against globalization.

Lori Wainwright
 Director

Public Citizen's Global Trade Watch
 Washington, D.C.

Your special issue paints an alternative real picture of the turbulence that we can expect to face. As we move into the millennium, we are entering a time of constant change. There will be time-outs, no substitutions. With

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s, we will look back at the 1990s as good old days."

such an environment, gaining and maintaining marketplace advantage will increasingly be difficult. Consumer demands, new technologies, and even the principles of an information-based economy will work against long-term market dominance as we have known it in the past. In the 21st century economy—becoming—and remaining—the winner in your markets will require an increasing ability to make the right decisions and to execute those decisions more effectively than your competitors. Darwin once said, it is not the strongest species that survive nor the most intelligent, but the most responsive to change. Building corporate nimbleness will be the competitive advantage in the 21st century.

Brian Gorman
New York

In this period of smug complacency, we celebrate current American success. When you make two judgments I think are wrong: The space program and nuclear power are not failed enterprises. People everywhere want the benefits of a modern economy, but earth has inefficient conventional resources for that purpose. Combustion technologies (coal, etc.) cannot provide enough energy, and they are destroying the global life-support system. Only thermoelectric power may provide high energy at an acceptable environmental cost. The future environmental problem will be disposing of excess

As I see it, the explosive growth in the 21st century will result from human exploration and colonization of our solar system. The effects of space travel will be analogous to Columbus' "discovery" of America. There is no reason food and basic materials cannot be economically produced outside earth. Doing so is economically justified, since it removes the environmental side effects of production. (But pollution by nuclear rocket fuels needs fixing.)

I knew in 1950 that we would go to the moon. Now I know we will go much further. The remaining question is, who do this if not Americans?

Walter L. Battaglia
Davis, Calif.

I was disappointed that your article did not include any discussion of the factors that encourage innovation in employees. How organizations are designed, people are developed, communicated to, paid, rewarded, and recognized, has significant impact on innovation and productivity. Many of today's technically updated managers are

still using outdated techniques to motivate employees, despite available data to the contrary.

Richard W. Park
Houston

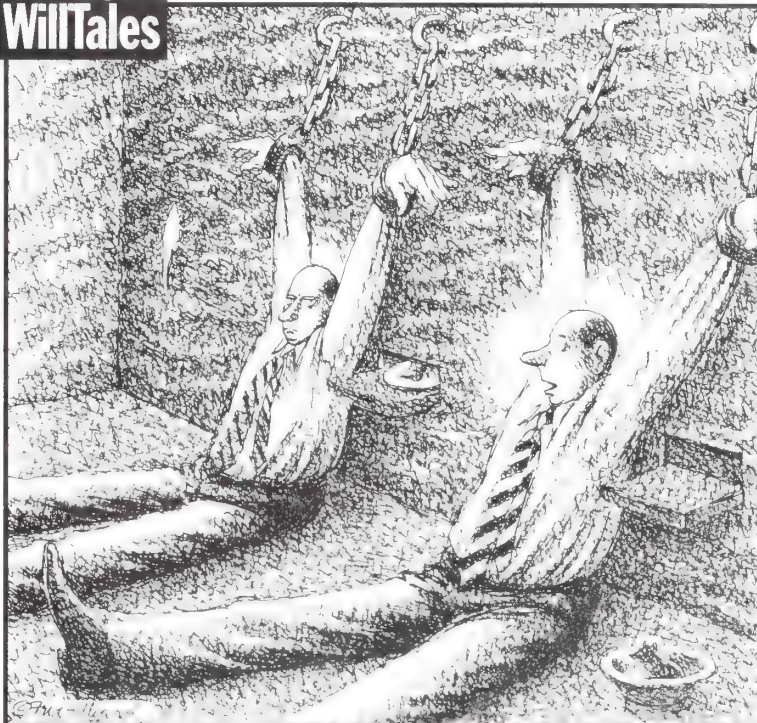
"Why the pace has to pick up" was an excellent exposition of the role that research and development must play in keeping our expansion rolling. The treatment of the role of the federal government in national research and development was also right on target,

highlighting both the problems and accomplishments achieved. Still, it should have added more detail as to how and why that government effort, spearheaded by the Defense Dept. agency, Defense Advanced Research Project Agency, was so successful.

About 30 years ago, DARPA foresaw the overwhelming potential for information systems and initiated major R&D efforts into technologies for very high-speed processing and for a revolutionary concept of computer communication net-

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KPMG

It's time for clarity.

Readers Report

CORRECTIONS & CLARIFICATIONS

"I want to lead with love, not fear" (People, Aug. 17) incorrectly identified Carlson Cos.' commercial and consumer travel businesses. They are Carlson Wagonlit Travel, which it co-owns with Paris-based Accor, and Carlson Leisure Group. The story also misstated revenues for Gage Marketing Group. The correct number is \$600 million in 1997 revenues.

working. Its highly talented people developed a vision for the future and then spent half their time traveling around the country, establishing contracts with university and industry researchers. They then proceeded to define and fund an incredible research and development effort. DARPA essentially ran a virtual R&D lab across the whole country.

These efforts were of such a magnitude that no one company could have realistically funded them. The results were essentially given away to American industry, resulting in a rapid and effective dissemination of technology. Throughout this effort, DARPA and other branches of the U.S. government ab-

solutely insisted that architectural standards for computer networking be developed and adhered to so that all network participants could easily communicate and share information. What is more, the DARPA effort was paid for not by industry or university dollars, but by the American taxpayer, and that effort—more than anything else—is responsible for the Information Age of the 1990s.

Gino J. Coviello
Palm Coast, Fla.

Let me present an opposite opinion from that expressed in "Alan Greenspan: An unlikely guru." I think it is possible that Greenspan, rather than accepting the New Economy is still fighting the last war (on inflation)—except that his hands have been tied from almost-certain tightening by the impact of the strong dollar on collapsing currencies abroad. That still hasn't stopped him from pursuing a tight monetary policy, which has nearly inverted the yield curve.

What some see as important are not actual interest rates but relative ones. The dramatic fall in long-term rates without even a modest easing in short-

term ones has in effect been the same as a massive tightening. Based on public comments, Greenspan does seem to understand what commodity prices and long-term rates are screaming at him: that inflation is not the gey man waiting in the closet anymore. Rather, it is a worldwide spiraling inflation produced in part by overcapacity and not enough growth of consumer goods worldwide.

Deflation could prove as damaging to Greenspan's worst fears about inflation. It's not as perfect a world as he imagines. We have seen only the benefits of disinflation so far, not the detriment of deflation. No one knows what will happen or if it could have been averted, but for Mr. Greenspan not to consider the problem in its entirety and remain with his head stuck in the inflationary sand is worrisome. It's not that the economy is different this time, it's that we haven't seen major deflation in our lifetimes, and we all think it's something new.

What [the Fed Chairman] may grasp in time is that long-term falling interest rates are not going to stop growth (much less inflation) because there is no outlet for production.



lower rates push up overvalued
for long, much less stop their
e.

easing sooner rather than later
rt-term rates could help, though,
ke the dollar less attractive to a
n, bubble-producing asset inflow,
then other currencies in free fall,
rescue export businesses so many
depend upon. Maybe there isn't a
ut, but some of these "visionaries"
etter come up with something to
st deflect the deflationary tsunami

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that is possibly headed our way instead
of pushing it along.

Robert Boutiere
Fairfield, Ohio

DON'T BLAME IMF AUSTERITY FOR KOREA'S WOES

Allow me to correct some mispercep-
tions about monetary policy in Korea
under its International Monetary Fund-
supported program ("Austerity isn't
working in Asia" Editorials, Aug. 17).
No one wants a prolonged period of
very high interest rates if it can be
avoided, but sometimes, interest rates
need to be raised during a crisis to de-
fend a plummeting exchange rate. In-
deed, the experience of other countries
has shown that a short period of higher
interest rates, along with necessary fi-
nancial-sector reforms, can help stabilize
the situation and avoid a longer and
more debilitating crisis.

This strategy is working in Korea.
As the won depreciated sharply in late
1997, short-term interest rates were
raised significantly, reaching a peak of
around 30% at the end of December,
1997. But as the won stabilized and be-
gan to appreciate in early 1998, short-
term interest rates steadily declined to
18% by the end of April and to less
than 10% by the beginning of August.

So real interest rates are now below
historical levels. Fiscal policy has also
been eased considerably.

Korea has undoubtedly paid a high
price for the financial- and corporate-
sector problems that lay at the heart of
the crisis. But to attribute these costs to
IMF-enforced austerity is mistaken.

Bijan B. Aghevi

Deputy Director, Asia & Pacific Dept.
International Monetary Fund
Washington

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THE MICROSOFT FILE

The Secret Case Against Bill Gates

By Wendy Goldman Rohm

Times Business • 313pp • \$25.95

MICROSOFT UNDER THE MICROSCOPE

On page 37 of Wendy Goldman Rohm's new book, *The Microsoft File: The Secret Case Against Bill Gates*, Microsoft Corp.'s CEO is described sitting in a restaurant in 1991 with a prostitute at his side. According to Rohm, Gates is thinking by turns about the weather (it's cloudy), the Federal Trade Commission's investigation into his software empire (it irritates him), and his companion (she's lovely). Rohm has him musing to himself: "Now this one was like a friend—she was smart and very, very beautiful. What did it matter that it had all been arranged?"

A better question is: What's wrong with this picture? The simple answer is that it seems to be at least partly fiction—in a book that purports to be entirely factual. That's not to say the event didn't happen. It is possible that Gates had such a liaison. (Rohm says yes, Microsoft no.) But what tests our credulity is this: Rohm, an experienced freelance reporter who got no help for her book from Microsoft's man, could not have known Gates's thoughts.

It's a pity that Rohm cluttered *The Microsoft File* with this and other silly scenes that go inside her characters' heads. At its core, the book is an earnest work of journalism with a serious purpose: to show that Gates and Microsoft have engaged in predatory business practices that all but destroyed competition in the PC operating-system market and now threaten to do the same with the Internet and electronic commerce. The book is being released in early September to coincide with the start of Microsoft's federal antitrust trial.

Rohm clearly spent years poring over documents and interviewing hundreds of government lawyers and computer industry leaders. She traces Microsoft's path as it uses its clout as the dominant supplier of PC operating systems to squash such rivals as Novell, Borland

International, and WordPerfect. She details how Microsoft headed off the threat of Novell's DR-DOS operating system by forcing PC makers to pay for Microsoft's MS-DOS product on every machine—whether they shipped a copy or not.

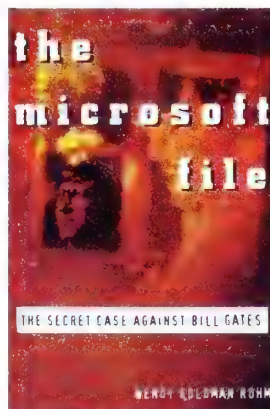
Especially compelling are Microsoft E-mail messages, apparently obtained from Federal Trade Commission files, showing Microsoft sabotaging DR-DOS. In 1991, she says, Microsoft warned users of a test version of Windows 3.1 that it might not work well on any operating system other than MS-DOS. And she produces evidence that the company at least considered guaranteeing that it was so. "It's pretty clear that we need to make sure Windows 3.1 only runs on top of MS-DOS..." says a 1991 memo by Microsoft Vice-President David Cole. Another titillating tidbit: On the day before a crucial 1989 meeting between Microsoft and IBM executives, a security man purportedly found three listening devices in the hotel room of IBM PC operating-system chief James Cannavino. Whodunnit? Rohm doesn't say explicitly, but the clear implication is that it was Microsoft.

That's as good as Rohm's story gets—and that's not very good. Her source documents come from the paper trail gathered, over the past eight years, by the FTC and the Justice Dept. There's little new here except for stringing it all together. There's also no sign of the "secret" teased in the book's title. And the last chapter, on Justice's antitrust case against Microsoft, reads like it was ripped off from the wire services.

Perhaps that's why Rohm adopted such a panting prose style. The Gates dinner-with-prostitute tableau is simply

the most sensational of several zez rendered scenes, many of which in the minds of participants who seem likely to have shared their thou Here's a half-awake Gates, meditating during a long flight to Australia: was like one of those vast but er beaches... Love, at first, was like a won in a competition. Soon, it became something else. Most everything had tendency." Elsewhere, we get a s as viewed through the eyes of William Neukom, Microsoft's senior vice-president for law and corporate affairs, resting on a bed in the Hay-Adams Hotel in Washington, D.C.

Rohm describes herself as an investigative reporter. And she has solid credentials, writing for the likes of *Chicago Tribune* and the *Boston Globe*. But Rohm seems to have lost her bearings as a journalist. Instead, she's pioneering a new genre—call it investigative fiction. And this fanciful approach raises questions about the credibility of everything she has written here.



What does Rohm have to say for herself? In an e-mail exchange with this viewer, she says all of these scenes are products of her own observations or of interviews with witnesses. She insists that she never tried to give the impression that she knew what anyone was thinking. The prostitute scene, she says, is important because it shows how Gates operates, regularly mixing business with

pleasure. "If my goal was to simply embarrass Gates, I would have printed many more sordid details," she counters.

Rohm says she wanted to be more open about her sources. But according to a Times Books spokesperson, the publisher and author chose not to print a source list, since that would give Gates a road map to her informants. As a result, her book has almost no source for its document-based assertions—we learn little about how Rohm got even the basic bits of data.

The result of all of this is a book that is by turns salacious, unbelievable, and dated. Not a good mix at all.

BY STEVE HAMM

Hamm covers the software industry from Silicon Valley.

AUTHOR ROHM HAS DONE LOTS OF RESEARCH. BUT HOW DOES SHE KNOW WHAT BILL IS THINKING?

EPHEN H. WILDSTROM

HERE WINTEL MARS TO TREAD

Apple's iMac design is
and cutting-
But is it too
a change?

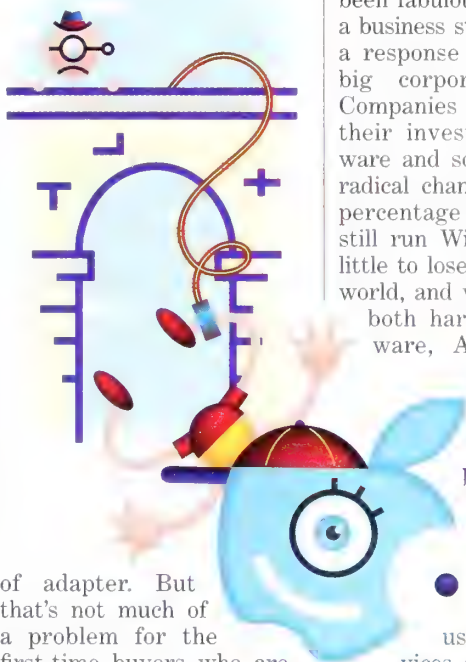
After several years wandering in the wilderness, Apple is. While it may never re- influence it held in early days of personal iting, Apple Computer in turning out exciting ts and breaking the . This is good news for e confronted with prod- hat, even as they keep g faster and cheaper, most as commoditylike eat.

key evidence of Ap- comeback as a major in design is, of course, w iMac. Beyond its fic appearance, the teal- white iMac represents a break with the past. onservative, Microsoft/ dominated PC industry never have tried such arture.

Consider Apple's decision it a built-in floppy drive. ogic is that floppies are vant because it's so easy change files over a net-. Apple may have got- bit ahead of itself here: de of corporations and e campuses, networks till the exception. This ion is particularly likely art Apple in the K-12 d market, where floppies till widely used to store ts' personal files. Ex- for the absence of a flop- rive, the iMac is other- perfect for schools.

other respects, Apple's gness to leave the past d led to happier results.

Apple threw out four systems it has used to connect accessories to Macintoshes and put all of its chips on the Intel-designed universal serial bus. USB is a single connector that can really make plug-and-play work for a seemingly endless array of devices, whether a mouse, a printer, a scanner, or a game controller. Now, every existing Mac peripheral is unusable on the iMac or, at best, requires some sort



of adapter. But that's not much of a problem for the first-time buyers who are iMac's target audience, and USB is better and simpler than the older connectors.

Contrast the Microsoft/Intel handling of USB. PC makers have simply added the bus to the confusion of connectors already present on their machines. Most desktop PCs now have five types of ports for external accessories

(not counting audio and video connectors) and two types of slots for internal cards.

Similarly, the decision to let Windows 98 (and Windows 95 before it) run just about every program for the IBM PC carried a price. People run old software that regularly crashes the system. Apple, on the other hand, has repeatedly forced software publishers to rewrite their programs for new hardware or new versions of the Mac operating system. And the next version, OS X, due out next year, may require the new G3 processor to run. That means the new operating system won't run Macs sold only a few months ago, although Apple promises that most new software will run on the current OS 8.1.

BAYWATCH. The Microsoft/Intel conservatism, which has been fabulously successful as a business strategy, is largely a response to the needs of big corporate customers. Companies want to protect their investments in hardware and software and hate radical change—a significant percentage of corporations still run Windows 3.1. With little to lose in the corporate world, and with control over both hardware and software, Apple has more

freedom to innovate. For example, Intel and PC makers have been squabbling for a couple of years over the design of a laptop-like bay that would allow users to swap devices such as disk drives and DVD players in desktop computers.

Apple could show the way by putting such a device bay in its next desktops. That's the sort of innovation that can bring real benefits to consumers. The reborn Apple, in turn, could solidify its place in the market—and the hearts of its fans.

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HANDHELDS

REPOTTING YOUR PALM ...

Owners of older PalmPilots who want the features of the new Palm III but don't feel like spending \$400 to buy one have a couple of intriguing options. The \$129 Palm 2-megabyte memory upgrade from 3Com (650 237-6000) provides Palm III features, including expanded memory, larger fonts, improved applications programs, and even the ability to exchange data with other Palms over an infrared link. (Older models without backlit screens won't gain this feature, though.)

The upgrade replaces the existing memory card (you must back up your data before installing it), and sliding off the cover of your Palm to get at the card is a breeze. The only tool required is a paperclip or pin to push the Pilot's reset button when you're finished.



... AND ADDING A PACER

The \$169 Synapse Pager Card from PageMart (800 381-4357 or 214 765-4000) takes a different tack. It adds most Palm III features, but trades the infrared capability for a tiny radio and circuitry that turns the Pilot into a Motorola one-way pager that can receive pages and E-mail. Installation is similar to the Palm upgrade, but in addition to buying the card, you must pay a \$20 activation fee and subscribe to a PageMart service, with options beginning at \$12.95 a month. Remember: You can't choose both upgrades. You will have to pick one or the other.



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serious
consideration

Several years of full employment, a booming stock market, and a growing economy have all contributed to a rapid expansion in tax revenues. During the next decade, according to the Congressional Budget Office, this could produce cumulative budget surpluses of more than \$1.5 trillion. These surpluses could make possible very desirable tax relief to the many families that have seen their taxes increase since the bipartisan tax act of 1986. Unfortunately, substantial tax cuts are unlikely because of what has been called the "flypaper effect": Governments tend to spend the revenues they receive.

Government expenditures reflect political battles between taxpayers and powerful interest groups that clamor for greater subsidies. Taxpayers always resist higher tax rates, but their resistance hardens when government accounts are in deficit, which helps slow the expansion of government spending. However, government outlays readily expand after revenues boom, since greater spending can then be financed without higher tax rates, and possibly even with some reductions.

This common-sense view that the main brake on government spending comes from tax revenues is confirmed by what happened to past budget surpluses. John F. Cogan of the Hoover Institution examined Federal responses to Social Security surpluses during the previous 50 years. His findings showed that Congress allocated these surpluses either to raise benefits, expand eligibility, or allocate funds for other purposes.

Cogan also found that Social Security benefits are often increased shortly before elections—a relevant point now, with this November's congressional battles looming. Both Republicans and Democrats have proposed that part of the budget surplus be set aside to fund future retirement benefits. Republicans tend to favor using surplus revenues to establish individual retirement accounts, whereas Democrats prefer shoring up benefits under the government's pay-as-you-go system.

This is typical of what happens to other budget surpluses. My University of Chicago colleague Casey B. Mulligan and I studied the effects of revenue windfalls in different nations during the past several decades. We found that unexpected increases in government revenue are generally devoted not to tax relief but to expanding old programs and creating new ones.

Oil-producing nations spent liberally on new construction and other programs after revenues boomed during the 1970s and '80s, then reined in their plans when prices fell. The current slump in world oil prices is forcing Middle East sheikdoms, Venezuela, Mexico, and other major producers to abandon some grandiose spending plans.

We do find that sometimes, surpluses lead to lower taxes, as when income tax rates were reduced following World War II in response to the large decline in military spending. Even then, however, income tax rates remained far above prewar levels because federal spending stayed permanently high.

Budget surpluses generate higher spending, which often becomes permanent, even if the budget goes from surplus to deficit. It is extremely hard politically to cut back government programs once they have been expanded, since subsidized groups fight hard and nail to preserve their benefits.

DISGUISED BURDEN. Some politicians are making noise about using projected surpluses to cut taxes, but a few simple questions expose the shallowness of their arguments. Are Republicans in Congress who want to convert the Social Security system to a system of individual accounts, which is an excellent idea, proposing to reduce the Social Security tax on employees and employers from its total of 14%? If not, their suggestion amounts to a disguised increase in an already heavy Social Security tax burden.

Are Democrats who want to improve prenatal care or expand coverage to the 4 million persons without protection against serious illnesses proposing to reduce other government-financed health expenditures, such as generous Medicare subsidies to wealthy retirees? After all, it could hardly be claimed that America is neglecting the health of its elderly when medical spending is almost 15% of the national product, a higher percentage than any other industrial country.

Unless taxpayers become more effective politically than they have been in the past, the anticipated Federal budget surplus will be directed mainly toward increased spending rather than devoted to reducing taxes. But aroused and politically powerful taxpayers may yet be able to overcome the flypaper effect and force politicians to give them back some of their own money through substantial tax relief.

A portrait of Wendy Jeansonne, a woman with short blonde hair, smiling and wearing a dark blazer over a white top. The background is a soft-focus office setting with blue and yellow elements.

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IMATION

BY GENE KORETZ

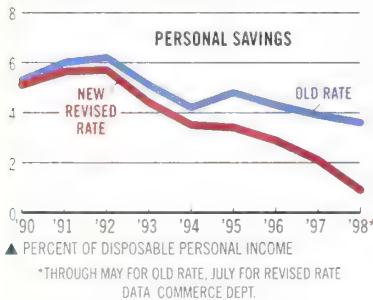
SAVINGS' DEATH IS EXAGGERATED

Capital-gains taxes skew the rate

What a difference a data revision can make. Only a few months ago, economists were pointing out that the slide in the personal-savings rate—saving as a percent of disposable income—was exaggerated because of a problem in the way the number was constructed (BW-June 29).

Then, in midsummer, the Commerce Dept. revised the rate downward, from around 3.6% to just 0.6% in the second quarter, setting off alarm bells in the financial markets. If people were really spending virtually all of their income,

HOUSEHOLD SAVINGS' NEW DISAPPEARING ACT



the reasoning went, a sharp retrenchment in consumer spending could be in the wings.

Moreover, the specter of disappearing savings was cited as evidence that consumption and economic growth were being driven by a "wealth effect"—that is, by people with big capital gains in the stock market who had decided to rev up their spending and draw down their savings. This implied that the expansion was acutely vulnerable to a stock market correction.

What has escaped notice, however, says economist Peter D'Antonio of Citibank, is that the latest revision in the savings rate still fails to address the basic problem with the numbers: the inconsistent treatment of capital gains and capital-gains taxes.

The savings rate is expressed as a percent of disposable personal income, which by definition includes current income such as wages and salaries, interest, dividends and rent—but doesn't include realized or unrealized capital gains.

Yet capital-gains taxes are subtracted from personal income to calculate "disposable income." And since capital gains have exploded in recent years, taxes on these gains have soared as well—reducing disposable income and the reported savings rate.

The upshot, says D'Antonio, is that half of the decline in the savings rate over the past year can probably be attributed to the sharp rise in capital-gains taxes rather than to a jump in spending. Joel L. Prakken, chairman of Macroeconomic Advisers in St. Louis, estimates that the current rate would be well over a percentage point higher without the tax effect. (His own view is that a better measure of savings would reflect both capital-gains taxes and realized and unrealized capital gains.)

To Citibank's D'Antonio, all of this implies that the wealth effect is less powerful and slower acting than many analysts seem to believe. Personal savings are not as depressed as they appear, and fears of a sudden sharp contraction in consumption caused by a market correction are exaggerated.

DOES HIRING MINORITIES HURT?

Affirmative action and productivity

Critics of affirmative action often claim that it causes employers to hire less qualified and productive workers, resulting in inefficiencies in the workplace. Advocates contend that it has generally spurred the hiring of more women and minorities without compromising work performance.

To determine which view is more accurate, economists Harry J. Holzer and David Neumark of Michigan State University analyzed the results of a survey of some 3,200 employers in the Atlanta, Boston, Detroit, and Los Angeles areas from 1992 to 1994. Their findings suggest that affirmative action programs have little if any negative effect on worker productivity.

The survey results indicate that employers who stress affirmative action in their recruiting programs make extensive efforts to attract and screen job applicants. They also are more likely to provide training to those they do hire and to evaluate their performance carefully. While such efforts enable companies to hire more female and minority workers, the survey results indicate that aside from educational backgrounds, the qualifications and—more important—the

work performance of such hires are par with other employees.

To be sure, those employers who affirmative action policies are focused more directly on hiring and who engage in strong "outreach" recruitment efforts, do indicate that they are likely to hire less-qualified females and minorities. But even these workers' performance does not appear to suffer, probably because their employers tend to provide them with more training to bring them up to snuff.

In short, claims that affirmative action entails costs in terms of lower worker productivity aren't borne out by employer reports.

WHERE EUROPE LAGS IN JOBS

Low-education sectors have shrunk

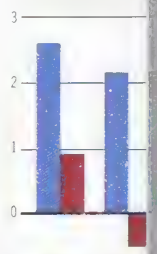
One clue to why employment growth has been so robust in the U.S. has been so weak in Europe in recent decades: the job gains in industry sectors requiring different levels of educational attainment. According to a recent ILO report, job-growth rates in education sectors in Europe and America have been "roughly comparable." From 1980 to 1996, employment in education sectors (where at least 30% of full-time U.S. workers have college degrees) grew at a 2.6% annual rate in the U.S., an average 2.2% pace in France, Germany, Britain, and Italy.

By contrast, employment in low-education sectors (less than 30% college grads) shrank in all four European countries while rising at a nearly 1% annual rate in the U.S. Since the majority of workers in both the U.S. and Europe are in lower-education sectors, Europe's lagging job growth has clearly been concentrated in such industries. Labor market features that probably contribute to this development include Europe's high minimum wages, high firing costs, and regulations inhibiting expansion in retail and other service industries.

U.S. vs. EUROPE WHERE JOBS GROW

ANNUAL GROWTH IN JOBS 1980-1996

■ HIGH-EDUCATION SECTORS
■ LOWER-EDUCATION SECTORS



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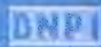
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JAMES C. COOPER & KATHLEEN MADIGAN

THE ENGINE IS SLOWED BUT NOT STALLED

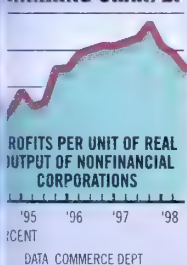
Profits recession and slumping stock prices take growth down a notch

U.S. ECONOMY

After a bone-crushing drop in the U.S. stock market amid another round of global turmoil and poor profit news, it is becoming increasingly obvious that prospects for the U.S. economy are now dimmer than they had been. Many forecasters are lowering their sights on economic growth, and recession worries are even starting to creep up.

At this point, recession talk is far too hasty given stilling labor markets, record low long-term interest rates, and benign inflation. However, it is clear that the economy is getting hammered on a number of fronts that are interrelated and have recently begun to feed on each other. In particular, three developments argue that economic growth will slip to a pace of about 2% in coming quarters, after zipping along at nearly 4% for two years.

PROFIT MARGINS ARE SHRINKING SHARPLY



First, the 19% plunge in the Dow Jones industrial average from its July 17 peak to the dramatic 512-point tumble on Aug. 31 will hit confidence and spending decisions of both households and businesses. Even with a recovery of 288 points on Sept. 1, the Dow is still down 16% from its high. Up to now, wealth gains from ever-higher

stock prices had nourished consumer outlays, especially housing demand, and cheap equity financing has been a major prop under capital spending. Now, those supports are crumbling.

Second, the new round of global market mayhem, led by Russia's debt default and growing perceptions of a U.S. leadership crisis, will very likely constrict world economic growth another notch. That means the trade deficit may well be a drag on U.S. growth throughout 1998 and into 1999.

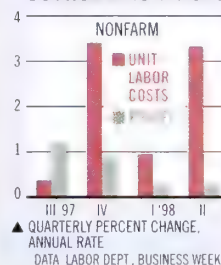
PROFIT, AND MOST IMPORTANT,

employment is already in recession—profits. Government data from some 20,000 companies show that profits of nonfinancial Corporate America are in a decline that is already close to the one that occurred during the 1990-91 recession, and the squeeze on margins is severe (chart). Weaker profits, along with slumping stock prices, are a double hit for capital spending. What's more, the problem with profits runs much

deeper than Asian and other global factors. The main squeeze on earnings is from higher labor costs that are outstripping companies' ability to raise prices, and that pressure will not let up any time soon. That could mean more trouble for Wall Street. Stock investors who believe analysts' expectations that earnings will rebound may be sorely disappointed when the third- and fourth-quarter earnings seasons roll around.

The Commerce Dept.'s roundup of second-quarter corporate profits shows that earnings, adjusted for inventory valuations and the difference between tax-based and replacement-cost accounting, fell 1.1% from the first-quarter level, and they are down 2.5% from their peak in the third quarter of last year. That was the weakest three-quarter showing in five years—at a time when gross domestic product has been increasing at a 3.4% clip. If earnings are falling in that kind of growth climate, what's going to happen when the economy slows substantially in coming quarters?

LABOR COSTS ARE OUTRUNNING PRICES



MOREOVER, THE EARNINGS RESULTS

would have been worse without the excellent performance of financial companies, reflecting recent boom times on Wall Street. Second-quarter profits at financial companies were up 7.9% from the third quarter of 1997, but earnings at nonfinancial businesses—72% of the total—were down 4.4%. From here on, though, finance companies will also get hit. In addition, Commerce said that second-quarter weakness among nonfinancial business was not confined to export-sensitive manufacturers but also included service-sector businesses such as transportation and public utilities.

The biggest factor weighing on profits is labor costs (chart). Because of this economy's extremely tight job markets and low inflation, real compensation has accelerated to a pace that even good productivity gains cannot offset. As a result, unit labor costs in the nonfarm sector are up 2.4% in the past year, while prices are up 0.8%. That's the widest discrepancy in eight years, and it means, by definition, that profit margins are under severe pressure. The trouble is, that squeeze will not let up until labor markets ease,

and economic growth of 2% isn't slow enough for that to happen quickly.

THE DROP IN PROFITS by itself is troublesome, but what makes matters worse is that profits, the stock market, global markets, and world growth are now so intertwined that weakness in one feeds off and into the others.

This vicious cycle is behind the downward revision to both U.S. and world growth. Economists at J.P. Morgan & Co. have trimmed their forecast for 1998 global growth to 1.5%, from 1.8% on July 1. They're pegging 1999 growth at just 1.7% now, down from 2.3%. And on Sept. 1, the Organization for Economic Cooperation & Development also said it would likely cut its forecast for global growth.

Slower world growth will further pummel U.S. exports and widen the trade deficit. Already, export orders are down sharply, says the National Association of Purchasing Management. The NAPM reports that its industrial-activity index edged up to 49.4% in August, from 49.1% in July. But the index remains below the 50% mark that indicates that the factory sector is declining. A big reason: Export orders fell to the lowest level in the 10 years of data-gathering (chart).

Uneasiness about the global outlook is fueling the current bearish run on Wall Street. And collapsing stock prices, with their attending drop in household

wealth, will rein in spending gains in coming months.

Luckily for consumers, job and income growth do appear to be in any near-term danger. So consumer spending isn't likely to decline outright in any quarter. True, real consumer spending fell 0.4% in July, but that mostly reflected a giveback in motor-vehicle purchases after the end of generous rebates last spring. Real disposable income in July increased a solid 0.8%.

Still, housing and other big-ticket items may take hits if the value of stock portfolios continues to shrink. New single-family homes in July sold at an annual rate of 886,000, a small 1.6% drop from June's record 900,000. And the supply of unsold new homes remains quite low. That suggests that homebuilders will remain busy in the fall—the pace just won't be as frenetic as it was this spring and summer.

With growth in each sector of the economy likely to lose some steam, the overall outlook clearly has been brought down a notch. Could the slowdown turn into something more serious? For now, that's premature, but not impossible. Depending on the interaction of profits, the stock market, and the global economy, the risk of a sharper slowing cannot be ignored.



CANADA

IT'S BEEN A LONG, COLD SUMMER

After watching the Canadian dollar slide by over 11% in the past year—and 6.8% since June 1—the Bank of Canada finally moved. It hiked its benchmark bank rate from 5% to 6% on Aug. 27, when the loonie hit a historic low of 63.59¢ U.S. The move triggered a modest rebound to above 64¢.

But defending the loonie will take a toll on Canada's already-sputtering economy. On Aug. 31, the government reported that real gross domestic product in the second quarter grew at an annual rate of 1.8%, half the 3.4% pace of the opening quarter. And Sherry Cooper, chief economist for brokerage Nesbitt Burns, has lowered her forecast

to show real GDP climbing by less than 3% this year, down from 1997's booming 3.8% gain.

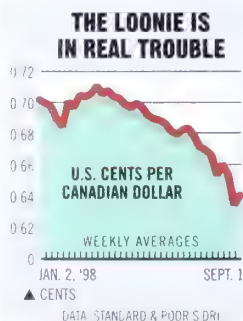
The slowdown will halt progress on unemployment. While the jobless rate is expected to dip to an eight-year low of 8% by yearend, from 8.4% now, the rate is then expected to average 8.2% next year. Rising unemployment and higher borrowing costs may cool activist sentiment among such groups as teachers, doctors, construction, and paper-mill workers who have staged strikes over the past year.

While scattered higher prices for food and other goods imported from the U.S. are appearing, slower growth generally will keep

inflation in check. Consumer prices may rise as little as 1.1% this year and 1.4% in 1999, down from a 1.6% increase in 1997. Despite the flat prices, however, consumer confidence is sliding, and personal income growth has slowed.

Still more troubling, Canada is vulnerable to the global slump in commodity prices because 10% of its economy remains dependent on natural resources such as minerals and timber. Moreover, renewed prospects for a secessionist vote in Quebec cast another shadow on the economy. If such clouds depress the loonie anew, the rate hike by the BOC may not be its last. One thing is sure, though: Shoring up the Canadian dollar already proving costly and may grow more so.

By Joseph Weber in Toronto



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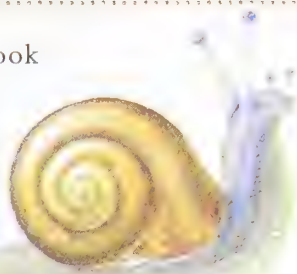


fig. 1



fig. 2

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TIME TO ACT

The forces wreaking havoc
can also lay the groundwork
for a resurgence of growth

COMMENTARY

By Bruce Nussbaum

Has the global economy come undone? Is the American model of free-market capitalism, the de facto ideology of the post-cold-war period, in retreat? There are many messages in the recent volatility of the stock market, but the most important may be that fundamental assumptions about the future of the American economy have been completely altered by the crises in Asia and Russia. Stock prices are reflecting a world that appears to be headed toward a deflationary slowdown, a world where countries are opting out of a free market system everyone took for granted. A revaluation of future profits and cur-

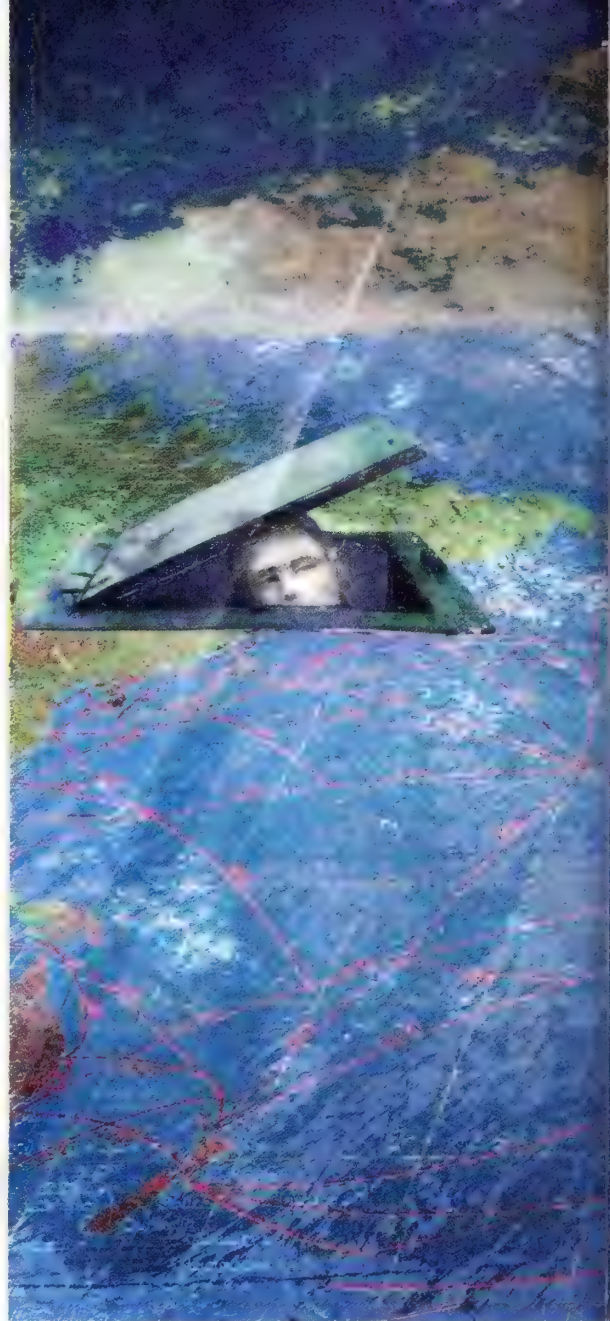
rent assets
is under
way.

It is clear
that the con-

Cover Story

tours of the crisis are different from anything we've seen in a long time. In severity and speed, it has taken most economists totally by surprise. Its deflationary core has unsettled policymakers accustomed to a lifetime of inflationary problems. The erosion of pricing power is startling corporate managers. Repudiation of debt is terrifying bankers.

There is a growing debate over whether the time has come for the U.S. to assert its leadership and act to stem the decline in the global economy. So far, the naysayers have had their way (page 38). They warn that U.S. labor



markets are still tight, growth is slowing—but not by much—and inflation remains a threat. Others argue that injecting new liquidity into the global economy now won't solve anything. Damaged economies and political paralysis in Asian countries and Russia will prevent them from using that liquidity to stimulate growth. All the money, they say, will find its way back to the U.S. and will wind up in U.S. Treasury bonds. Then there are those who argue that Washington must do nothing until Japan agrees to reform its banking system and Russia begins to collect taxes.

All these are legitimate views. Yet history shows that in deflationary times like these, the great risk is in doing nothing. Time and again, slowdowns have turned into recessions and recessions into depressions because governments have found excuses not to act.

To date, there has been a strong tendency for a beleaguered Administration and a once-euphoric Wall Street to play down the dangers in the Asian crisis. Warnings that a currency crisis and deflation would spread from Thailand to America's borders went unheeded. But any hopes that a



ress America or Continental Europe could wall themselves off from the spreading Asian contagion have proved foolhardy. Russia is at Europe's door. Canada and Mexico are already caught in the deflationary swirl. Danger signs are everywhere: Most U.S. stocks are down 25% or more from their highs as the quest for profit growth ends. Asia sinks further into depression as Hong Kong, Taiwan, and Malaysia try to insulate their markets from the effects of international capital flight. Japan heads into its fourth quarter of contraction, and Latin American leaders on the edge of yet

another recession. And the communists—the communists!—are on the verge of regaining a measure of power in Russia, following devaluation of the ruble.

The threats are not only for the short term. U.S. and

European companies have banked on decades of increasing demand from emerging markets to fuel profit growth. Now, they face a future of lower-than-expected demand. The stock market, which values companies on their future earnings potential, will continue to knock down prices as the prospects for world trade worsen.

That is the connection between the Asian conta-

THE GLOBAL CRISIS

TIME TO ACT

Here's what must be done **34**

WILL THE FED CUT RATES?

Greenspan is in no rush **38**

IT'S NOT SO BAD, HONEST...

But the best days are over **40**

PLAYING CONTRARIAN

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EMERGING-MARKET CARNAGE

Market makers take cover **50**

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Survival strategies for an imploding market **64**

gion and Wall Street. The U.S. has had a glorious investment-led expansion based on the assumption of rapid growth in the emerging world. With rising productivity and falling overseas demand, Corporate America may soon be faced with too much of everything—plants and equipment, workers, managers, suppliers. There is a discontinuity in the global system. Everything has changed.

If the U.S. acts now, there is nothing inevitable about any of this. Indeed, the very forces wreaking havoc from one continent to another are also laying the foundation for a powerful resurgence of growth. Asset revaluation across the globe is opening new opportunities for investment. Debt renunciations and bond losses are forcing a return to sober evaluation of risks. The stage is being set for a financial and economic rebound.

But first, the slide must be stopped. Someone must get in front of the TV cameras and say: "Enough. We have a plan."

Above all, the past year's sharp rise in real interest rates must be reversed. Tight monetary policies imposed by the International Monetary Fund and pressure from competitive devaluations have sent real interest rates sky-high throughout the emerging world. Banks aren't lending. Businesses are going bankrupt. The Asian middle class is being pushed back into poverty. The misguided tight-money policies of the IMF are making a bad situation much worse.

The big surprise, though, is the spike in real interest rates in the West and in Japan. Consumer inflation has slowed sharply, and central banks have held key short-term rates constant or even raised them. As a result, average real rates in Japan, Britain, France, Germany, Canada, and the U.S. have doubled since the first month of 1997, from 1.2% to 2.4%. Real rates rose from just over 2% to 3.3% in the U.S. and from 1.1% to 4.8% in Canada. Japan had a

rate of minus 0.1% in the first month of 1997. It is now up to a positive 0.6%.

There is plenty of

room in the industrialized world to ease. Because real rates have been rising rather than falling for the past two years, inflation risk is minimal. The U.S., in particular, has plenty of room to maneuver. The federal budget is in surplus, and rapid productivity growth provides insurance against inflation. BUSINESS WEEK believes that a coordinated cut in interest rates, led by Fed Chairman Alan Greenspan, is the most important single act needed to stabilize the global slide. The time to do it is now.

The next step should be a coordinated global workout of the debt overhang that is strangling economies in Asia and Russia. It should be led by Treasury Secretary Robert E. Rubin and his Japanese and German counterparts. Devaluations are being used to dampen domestic demand and generate trade surpluses to pay off these huge debts. Hedge

► CUT INTEREST RATES

Central bankers of the Group of Seven industrialized nations should coordinate cuts in interest rates to increase global liquidity

► LIQUIDATE BANKS

Governments should strike a deal to wipe out debts—and force banks to take a hit on their ill-advised loans

► CUT TAXES

To promote economic growth, the U.S., Japan, and Western Europe should cut tax rates

► KEEP MARKET OPEN

Congress should expedite NAFTA and give the International Monetary Fund an \$18 billion infusion—but only if the IMF adopts pro-growth policies



funds and private equity and bond investors are getting in for their ill-advised lending. But banks have escaped any penalty (except in Russia, which basically defaulted on its foreign debt). It's time for a haircut. A debt workout restored growth to Latin America in the '80s. It can work in Asia and Russia in the '90s.

Congress must commit, too. For far too long, its ambivalence toward American free market ideals has generated economic uncertainty. Unless it wants to be tarred as the answer to "who lost Russia and Asia," Congress must set aside narrow, parochial constituency concerns and provide the resources for U.S. global leadership. That means the funding for the IMF must be passed (in exchange for an end to its obsession with austerity) and NAFTA must be expedited. That is the best way for the GOP to make good on its commitment to free market ideology (page 150).

Tax cuts are in order as well. As global deflation pushes the U.S. economy into lower gear and consumers begin to retreat, a pro-growth tax cut makes sense. The payoff of higher productivity and the budget surplus give Washington the leeway to do it. Deep, broad-based cuts in marginal income tax rates reward productive work. And what goes for the U.S. goes for Japan and Western Europe, too.

Cover Story

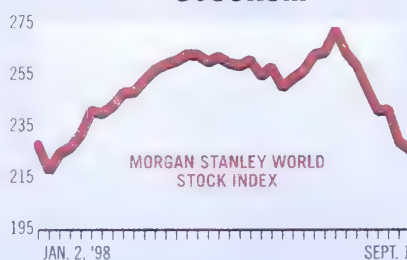
THE GLOBAL CRISIS

COMMODITY PRICES HAVE PLUNGED...

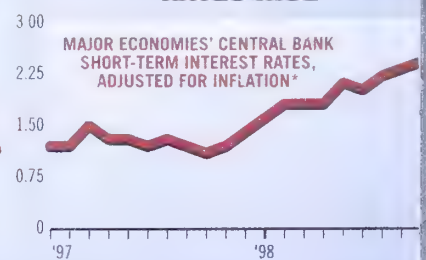


DATA: GOLDMAN, SACHS & CO.; MORGAN STANLEY, DEAN WITTER & CO.; STANDARD & POOR'S DRI; BUSINESS WEEK

...AND SO HAVE STOCKS...



...WHILE REAL INTEREST RATES RISE



*U.S., JAPAN, UNITED KINGDOM, FRANCE, GERMANY, AND CANADA, WEIGHTED

PLAN FOR ACTION

JAPAN AGAIN

Japan must finally
and boost
to restore
growth

HOT MONEY

Hot money
countries need
capital controls,
and beef up finan-
ciary and bank
regulation



The wild card is Japan. Political dithering over bank re-
has transformed a once-dynamic economy into a stag-
rentier society that favors its old over its young, its
ers over its urban population, its bureaucrats over its
preneurs. Tokyo must cut taxes dramatically and flood
system with liquidity to save itself and Asia.

There are enormous geopolitical reasons for acting now,
from the economic ones. The American model is un-
tack everywhere as the free market system is rolled
Hong Kong, the epitome of laissez-faire capitalism, is
vening in the stock market to prop up the stocks of
estate tycoons. As a result, the government owns 10%
of some of the biggest companies there. Taiwan effec-
tively makes its currency nontradable as the government
out businesses and intervenes in the stock market.
Russia is toying with capital and currency controls, while
Asia actually imposes them. Tokyo moves away from a
et solution to its banking crisis and pressures Toyota
Corp. to bail out Sakura Bank Ltd. Everywhere, the
market is increasingly perceived as the enemy of
growth. Increasingly, nations are opting out.

The retreat from the U.S. model is a reaction to one of
the greatest episodes of wealth destruction ever. In the
year, market declines of 50%, 70%, even 80% in Asia
led out hundreds of billions of dollars in asset wealth.

The real economy collapsed. The Korean economy has
contracted 5% over the past 12 months. Thailand is down
Indonesia nearly 20%. Some 100 million middle-class
people are being pushed back into poverty.

The consequences for global growth are immense. Econo-
mists at J.P. Morgan & Co. estimate that the global econo-
my will expand at a rate of 1.7% in 1999, half of the
growth rate before July, 1997, when the current crisis be-
gan. Asia alone was supposed to provide a third of world
economic growth over next decade. Add Latin America and
Eastern Europe, and emerging markets were supposed to
account for more than half of the growth. The danger is that un-
less action is taken to rescue Asia's middle class, much of
that demand will never be realized, cutting profit prospects

for corporations around the world and increasing global po-
litical instability. The Russian political crisis has as much to
do with falling oil prices as it does with evil tycoons.

The past few weeks have demonstrated the vulnerabilities
of the American model. For a decade after the end of the
cold war, the triumph of free markets appeared inevitable.
An expanding network of open capital and currency markets
generated enormous growth, wealth, and prosperity for mil-
lions. Without much effort, the U.S. consolidated its victory
over communism by bringing nearly all of the world's
economies into its orbit, playing by its free market rules.
Perhaps it was too easy. The benefits were so obvious.

The costs as well as the benefits of the American model
are becoming clearer. Last year, Asians stumbled about,
wondering how their prosperity could end just because of
one devaluation of one minor currency, the Thai baht. Now,
Americans are wondering how the stock market can be so
savaged because of the turmoil in Russia, a country with a
share of world trade the size of Denmark's.

The vitality of the U.S. model is being tested as never
before by the instability of free global markets. Those who
would roll the clock back charge that the too-hasty incorpo-
ration of what were once closed, communist, or crony capi-
talist economies into the free capital and currency markets
destabilized the global economy and caused the current cri-
sis. New forms of highly leveraged, high-octane capital
from hedge funds pumped too much money into their sys-
tems, leading to overcapacity, profitless sales, and massive
corruption. Recession, competitive devaluation, falling com-
modity prices, and political chaos followed. The solution, ac-
cording to the critics, is to restrain the markets with curbs
on capital and currency flows.

BUSINESS WEEK believes that just the opposite is true—
and the world must act now to prove it. It is the incomplete
integration of these closed economies into the free market
system that caused the trouble. There wasn't enough bank
regulation or credit evaluation in Asia or Russia to deal
with the hot-money flows. There wasn't enough transpar-
ency. Bureaucrats and politicians continued to supersede mar-
kets in channeling loans to real estate and profitless enter-
prises. We think the solution is more integration, not less;
more political reform within each emerging market, not
more regulation of the global capital system.

It is naive to think reform can be accomplished quickly,
without pain or reverses. But the deflationary spiral that is
sending the world economy into a downward spin must
first be stopped. The fight for structural reform will take
many decades. After all, it took the U.S. 25 years to re-
structure its economy and balance its budget after an oil
shock and the trauma of Japanese competition. Why expect
Russia and others to take less time to reform, especially
when it involves far more revolutionary changes for them?

Sure, reliquifying the global economy does bring risk.
There are legitimate concerns about reigniting inflation,
putting cash in crooked tycoon hands, or simply wasting
taxpayer money. But the U.S. took the same risks in
pouring money into the U.S. banking system in the '80s
to save it and the economy from collapse. The dangers in
an international rescue are obviously greater, but so is the
threat.

The U.S. must show leadership in coordinating a strong
international response to the spreading financial crisis. The
peace and prosperity of the world are at stake. Procrasti-
nation is the clear and present danger.

Bruce Nussbaum is the editorial page editor.

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NO SIGN OF THE DOVE, YET

Greenspan isn't likely to rock the monetary policy boat

As soon as the Federal Reserve's annual policy gabfest in Jackson Hole, Wyo., broke up on Aug. 30, Alan Greenspan dashed off to one of his favorite summer vacation spots, a tennis camp in California. But you can bet the Fed chairman had his hands full between sets. With Russia in chaos, Asia's currency crisis threatening to take down Latin America, and Wall Street buffeted, Greenspan is the man on the spot. Increasingly, traders, business leaders, and politicians are looking to him to bring stability to a wobbly global economy.

Their advice to Greenspan: a bold in-

officials say that if such a gloomy scenario came to pass, they might push for a coordinated rate reduction with central banks in Europe, where economic conditions also remain relatively strong. There is precedent: The U.S. has coordinated monetary policy with other governments in response to past global crises.

Still, as nervous as they are about global events, Fed officials appear in no rush to act—in part because they aren't sure a rate cut by itself is a magical salve for the world's ailments. True, lower U.S. rates would briefly help the few countries that peg their currencies to the dollar, such as Hong Kong and Brazil. A small rate cut not coordinated with any actions by other countries, however, would do little to pull Asia's struggling economies out of recession—and accomplish nothing in Russia, whose problems stem from a lack of political will to adopt market reforms. "How would a rate cut solve Boris Yeltsin's real problem—that he can't collect taxes?" asks one Fed official.

The economies of Korea, Thailand, and other Tigers will start to mend, Fed officials argue, only when they swallow the bitter medicine prescribed by the International Monetary Fund—

interest-rate cut by the U.S. central bank. It would aid emerging markets parched for liquidity and provide a psychological lift to investors who fear the global economy is in a deflationary spiral, they hope. National Association of Manufacturers President Jerry J. Jasinowski, for one, is imploring Greenspan to slash the federal funds rate, charged on overnight interbank loans, from 5.5% to 5%, to "help prevent the spread of worldwide recession." Ford Motor Co. Chief Economist Martin B. Zimmerman agrees on the need for a rate cut, taking note of the "risk that the financial market instability could erode consumer and business confidence."

But Greenspan is likely to spurn such appeals, at least for now. The Fed chief has long been praying for a slowdown of the U.S. economy and an orderly correction to an overheated stock market. Now that he has gotten both wishes, Greenspan is not about to rock the monetary-policy boat—as long as conditions on Main Street and Wall Street don't deteriorate much more.

EIGHTIES REDUX? Fed officials say that if more foreign currency crises erupt, sending U.S. markets down, say, an additional 10% or 20%—and creating a worldwide panic—Greenspan might be inclined to jump in with a rate cut to provide some psychological support to global markets. Indeed, some senior Fed



namely closing insolvent banks, financing their budgets, and ending incestuous ties between business and government.

That belief is shared by some Wall Street economists who say that without structural reforms in countries such as Indonesia or Russia, foreign investors are unlikely to return. They say the risk from a rate cut is that any extra liquidity created by the Fed might cy-

WHY NO COMPANY IS IMMUNE

A few months ago, Gillette Executive Vice-President Jorgen Wedel said Russian sales of its razors, batteries, and toothbrushes would more than double, to \$500 million in five years, from \$200 million in '97. Today, with the ruble in shambles and Russia retreating from market capitalism, that forecast has been reduced to rubble.

It might be bearable if the problems were confined to Russia. But with markets from Asia to Latin America also in or near crisis, "every multinational is going to have a much stronger headwind," says Jay H. Freedman, an ana-

lyst at Chicago investment firm Capital Management Co.

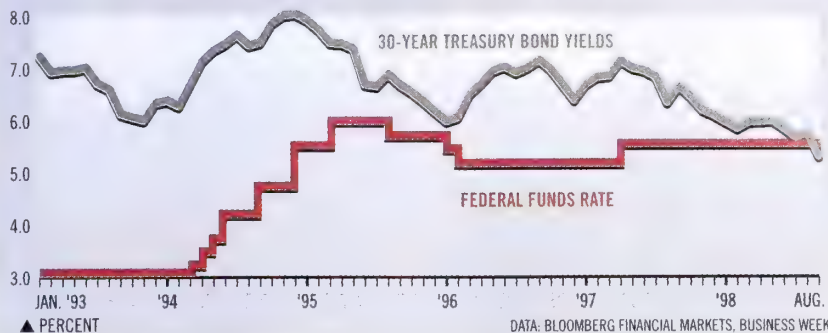
The damage won't be confined to most global companies, such as Coca-Cola Co. and Gillette Co. "There is a U.S. company that does not have global exposure, directly or indirectly," warns Maureen Allyn, chief economist at Scudder Kemper Investment Inc.

Take Chrysler Corp., which isn't in Russia at all and has just minor operations in Asia. "It's not our direct exposure to these areas that has been concerned," says Chairman Robert L. Ichniowski. "As it gets worse, that's starting to affect the multinational companies here... [and] the people who work for them." Ultimately, he adds, "that's going to affect the people who buy cars."

While a flood of cheap imports is distressing some countries, it is great for



THE FED HOLDS THE LINE ON INTEREST RATES



out of the question if the U.S. economy remains strong. "We'd be hard-pressed to do something that wasn't justified by domestic conditions," says one insider. "Our mandate is not to be the central bank to the world."

So far, the Fed sees few signs that the domestic economy is losing serious altitude. After a temporary lull in the second and third quarters in the wake of a massive eight-week strike at General Motors Corp.,

some Fed officials are bracing for a snap back in the fourth quarter. Some officials see the possibility of growth above 3%—double the estimated rate for second and third quarters—and maybe as high as 4%. One reason: GM is ramping up production as fast as it can to replenish inventories depleted by its strike. That alone could add as much as 1.5 percentage points of growth in the fourth quarter.

Still, Fed officials acknowledge that the risks have shifted from an overheated, inflation-prone U.S. economy to one at risk of being destabilized by a stock market crash or dragged down by the deflationary forces sweeping Asia. That's why St. Louis Fed President William Poole, who favored a rate hike in May, voted with other Fed policymakers to stand pat on rates in July. **CHAIN REACTION.** And while just a few months ago some Fed officials would have welcomed a stock market correction, today they admit they're watching closely to make sure that the downturn doesn't crimp consumer spending—and set off a chain of events that triggers a recession. That would justify monetary easing that would keep the economy from dipping into recession.

For Greenspan, the trick is to make sure the domestic economy stays strong enough to keep the world from drifting into a synchronized slump—and pulling the U.S. with it. If his interest-rate calls prove accurate, he may even find more time to work on his backhand.

By Dean Foust in Washington

WAITING GAME Fed insiders rule out a cut as long as the U.S. economy stays strong

back into the U.S. and other safe-markets, which are already awash in liquidity. "Monetary policy is not the answer for the rest of the world's problems," says John Lipsky, chief economist at Chase Manhattan Bank, who nonetheless believes the U.S. economy is strong enough on its own to warrant a rate cut. What's more, most of the Fed officials surveyed insist that a rate cut is

ners, it wreaks havoc on manufacturers. "The U.S. is a disproportionate part of the problem in these countries try to export out of crisis," complains Anwarkey, president of the Iron & Steel Institute. As of July 1, analysts surveyed by First Call Corp. thought the Standard & Poor's 500 would see 10% profit growth in the year. That number has now fallen to just 3.7%, says First Call research director, Charles L. Hill. He says that after Labor Day, "the stock market will go significantly lower." Standard & Poor's DRI says S&P 500 earnings will fall 3.2% for 1998 and then 5% in 1999. "Corporations are in a bind," says David A. Wyss, chief economist at DRI, a unit of BUSINESS



WEEK publisher The McGraw-Hill Companies. "Their employment costs are going up due to tight labor markets, but they can't pass it on due to the strong dollar and import competition."

Still, far from retreating, many multi-

WILL THINGS GO BETTER? Some multinationals see opportunity

nationals are boosting bets on emerging markets. Ford Motor Co. says it will keep bidding for insolvent Korean carmaker Kia Motors Corp. Campbell Soup Co. is also scouting for buys in Asia. "Mexico taught us that when there's a crisis, that's when smart people can move in," says Campbell CFO Basil L. Anderson. Indeed, Gillette is going ahead with a \$40 million plant in Russia's St. Petersburg. Ultimately, the crisis could leave prepared U.S. multinationals even stronger in emerging markets.

By William C. Symonds in Boston, with bureau reports

IT'S NOT SO BAD, HONEST...

But gurus say the highs for the year are behind us

Stock prices are showing all the stability of a kid on a pogo stick. They're gyrating between the fear that poorly understood forces abroad will infect the U.S. economy and the hope that the U.S. will continue to shake off the contagion, as it has to date. Fear won out on Aug. 31, when the Dow Jones industrial average tumbled 512 points. Hope claimed victory in the 288-point snapback on Sept. 1. It promises to be a long, hard slog to the end of the year, one that surely will leave few investors untouched.

Does the turbulence represent a pause in the bull market—or does it signal the onset of a bear market, even a recession? Many investment pros say the odds favor the relatively strong economic fundamentals of the U.S. market withstanding the global malaise.

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THE GLOBAL CRISIS

Most also believe, however, that stocks will not hit new highs in 1998 and that there's a good chance that the market has not yet hit bottom. The challenge is figuring out what fair value should be, given such a murky earnings outlook.

Investor jitters were very much on the minds of Merrill Lynch & Co. Chairman and CEO David H. Komansky and Merrill President Herbert M. Allison Jr. on Sept. 1. That morning, the pair warned Merrill employees in a memo that "selling in the equities markets



has reached an emotional stage... with further declines possible before a bottom is reached." That day, Merrill's quantitative strategist lowered his recommended allocation to equities from 55% to 50%.

For some market-watchers, the fear runs deeper. If policymakers abroad don't take strong action, some say, the malaise will only worsen and spread, and the likelihood of it spilling over into the U.S. will increase. "The biggest risk is if policymakers get stuck thinking inside the box," says Credit Suisse First Boston chief investment strategist Christine A. Callies. "If they're too concerned with the relatively short-term issues of currency valuations and so forth, that could lead to their not doing enough to help stabilize the global situation."

The fear that the Asian contagion will spread to Latin America and to America's trading partners in the North American Free Trade Agreement, Mexico and Canada, is a big factor in the recent market jitters. On the margin, export trade can be a swing factor for the economy, says Mitchell Held, co-

INVESTORS STAY JITTERY Fear runs high that Asia's ills may infect Mexico and even Canada

manager of U.S. economic research at Salomon & Barney.

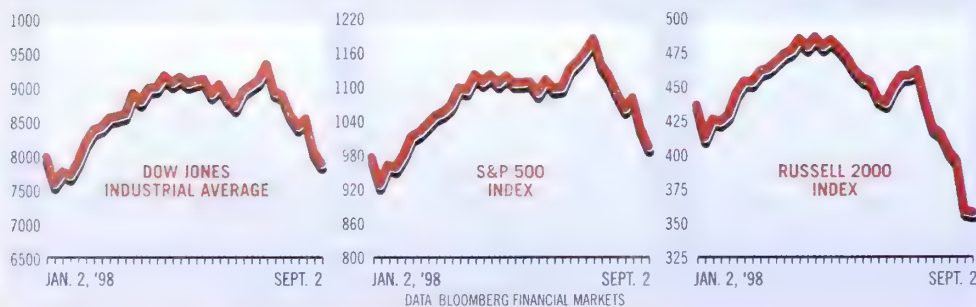
Abby Joseph Cohen, Goldman Sachs' bullish strategist, believes the strong fundamentals of the U.S. market can offset the global recession. She doesn't foresee a worldwide recession in 1998 or 1999 and thinks that a heaval in foreign markets

will ultimately have little impact on U.S. economic growth, corporate profitability, and cash flow. On Sept. 1, she upped her recommended stock weighting to 72% from 65%. With the Dow closing at 7539 on Aug. 31, Cohen pegged the market as 12% to 15% undervalued, using a Goldman Sachs transaction-based valuation model.

SKIMMING THE FROTH. With the average price of shares listed on the New York Stock Exchange sinking to \$38.50 on Sept. 1, down from the high of \$47.50 on July 17, a lot of froth has been skimmed from the market. Indeed, many models show the stock market to be at good value. Using a forecast of operating earnings of \$51 for the Standard & Poor's 500 stock index, and an interest rate of 5.5% on the corporate bond, Morgan Stanley & Witter's dividend discount model shows fair value for the S&P 500 at 105—about 6% above its Sept. 1 level. And with the corporate bond yield now at 5.3%, the market may be undervalued by about 11%.

The trouble with the models: They don't fully capture all the things that affect stock and bond prices, such as bonds' safe haven

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status today. "Our valuation model can't judge a flight to quality," says Brian F. Rauscher, U.S. investment strategist at Morgan Stanley Dean Witter.

Less bullish strategists than Cohen lay out a convincing scenario for weaker corporate earnings. In fact, earnings-growth estimates for the third quarter have slid from 8.6% on July 17, when the market peaked, to 3.2% on Sept. 1, according to First Call Corp. Their gloomy scenario: A spreading global meltdown that keeps stocks volatile, shakes consumer confidence, and curbs consumer spending. Prudential Securities Inc. strategist Greg A. Smith forecasts low-single-digit profit growth in 1999, since he doesn't see much reason to think revenue growth will expand with pricing power so weak worldwide. But a drag on earnings may be offset by a boost from lower interest rates.

If the stock market doesn't regain more ground soon, it could start cutting into expectations for economic growth. Down markets tend to slow consumer spending. Held says that if the U.S. stock market drops 10% and stays at the lower level for a prolonged period, the gross domestic product will be 0.7% lower than it would have been

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otherwise. The Dow has suffered a 17% drop from its mid-July peak. If a 20% correction dug its heels in, all else being equal, "you'd probably end up with below-trend GDP growth for 1999," he says. The trend for growth is 2% to 2.5%.

Some technical analysts see signs of a bottom. Ronald E. Elijah, portfolio manager of the Robertson Stephens Value + Growth Fund, points to an indicator tracked by Merrill Lynch's Richard McCabe. It shows the number of stocks on the New York Stock Exchange trading above their 200-day moving average. After peaking at 80% in late 1997, the reading fell below 19% the week of Aug. 24. According to McCabe, history shows readings near or below 20% to be "a deep oversold condition for the market, which can be one ingredient for a major bottom." Elijah is reassured by that—but isn't ready to buy yet. "I want to let things settle down," he says. "In such a frantic period, you can make so many mistakes."

Neither the bull nor the bear camp is likely to declare victory soon. In coming weeks, the market will react to third-quarter pre-announcements, which tend to be negative. In such an unsettled environment, investors can count on only one thing: They won't be bored.

By Suzanne Woolley in New York

SO YOU WANNA BE CONAN THE CONTRARIAN...

Amid the last great bear market, the 1973-74 fiesta that sent stocks halfway to oblivion, there was one guy couldn't stop buying. Even as other investors dumped their shares of such companies as Ford, Dean Witter, and Ogilvy & Mather, he snapped them up, using not just the cash he had saved but raising \$20 million more to keep going. It was pure contrarian bravura—and it worked for Warren E. Buffett.

Is today another such moment? That's debatable. But if you're intent on being a buyer right now, you're going to need the same raw material—cash—that the legendary investor could hardly get enough of 25 years back. And if you do your investing through mutual funds, consider focusing on those that went into the summer sell-off sitting atop tidy piles of the green stuff.

With stock prices 18% lower than they were just seven weeks ago, mutual-fund managers who are armed with plenty of cash have the means to make the most of the new market. "If you are looking to get into a fund," notes Kevin McDevitt, an analyst at Morningstar Inc., "you want someone who has cash on the sidelines and can take advantage of opportunities."

PICKING AND CHOOSING. To spot such funds within the 4,500 U.S. stock mutuals, BUSINESS WEEK searched Morningstar's Principia database and came up with a list of possibilities. We stuck to funds that are open to new investors for initial stakes of no more than \$5,000 and those that held at least 25% of their assets in cash before the market plunge.

What have these funds been doing with all that dough? In a word, buy-

ing. "We're getting a chance to buy things more on our terms," says Mark O. Robertson, a manager of Vontobel U.S. Value Fund. Its cash level early this summer ran at 33%. Now, it's closer to 20%, as the fund has bought blocks of McDonald's, Sherwin-Williams, Coca-Cola, and American International Group. Robertson now hopes to pick through the wreckage among big bank stocks such as J.P. Morgan & Co., down from its high

"It would be nice if we don't have a spike back up in the market and have the time to evaluate things," he says.

"FUSSY." Berger Select's Patrick S. Adams closed August with 38% of his fund in cash and swiftly cut that to 28% on Sept. 1 as he loaded up on technology, financial, and consumer stocks.

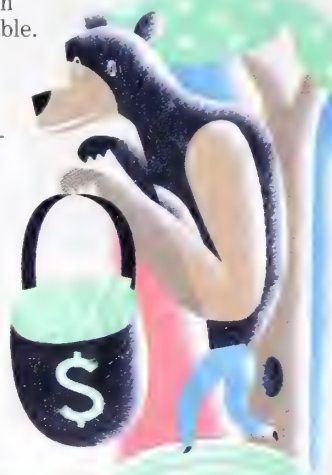
"It's just extraordinary, the carnage that has occurred," Adams says. "The bargains are much more prevalent now than in 1987."

Not everyone is so enthusiastic. "We're being

fussy buyers," says Michael Sandler, Clipper's co-manager. He aims to buy stocks in companies at 60% to 70% of their underlying value and reports finding few of those gems, even now. "I'm nibbling," says Oppenheimer Growth's manager, Robert C. Doll Jr.

Clipper and other cash-rich funds have suffered under loads of greenbacks that earned money-market rates while rivals, carried by the bull's long run, charged past. But if the market rallies again, these funds will have a turn to show what they can make of capitalism's most basic building block.

By Robert Barker in Melbourne Beach, Fla.



They've Got the Cash

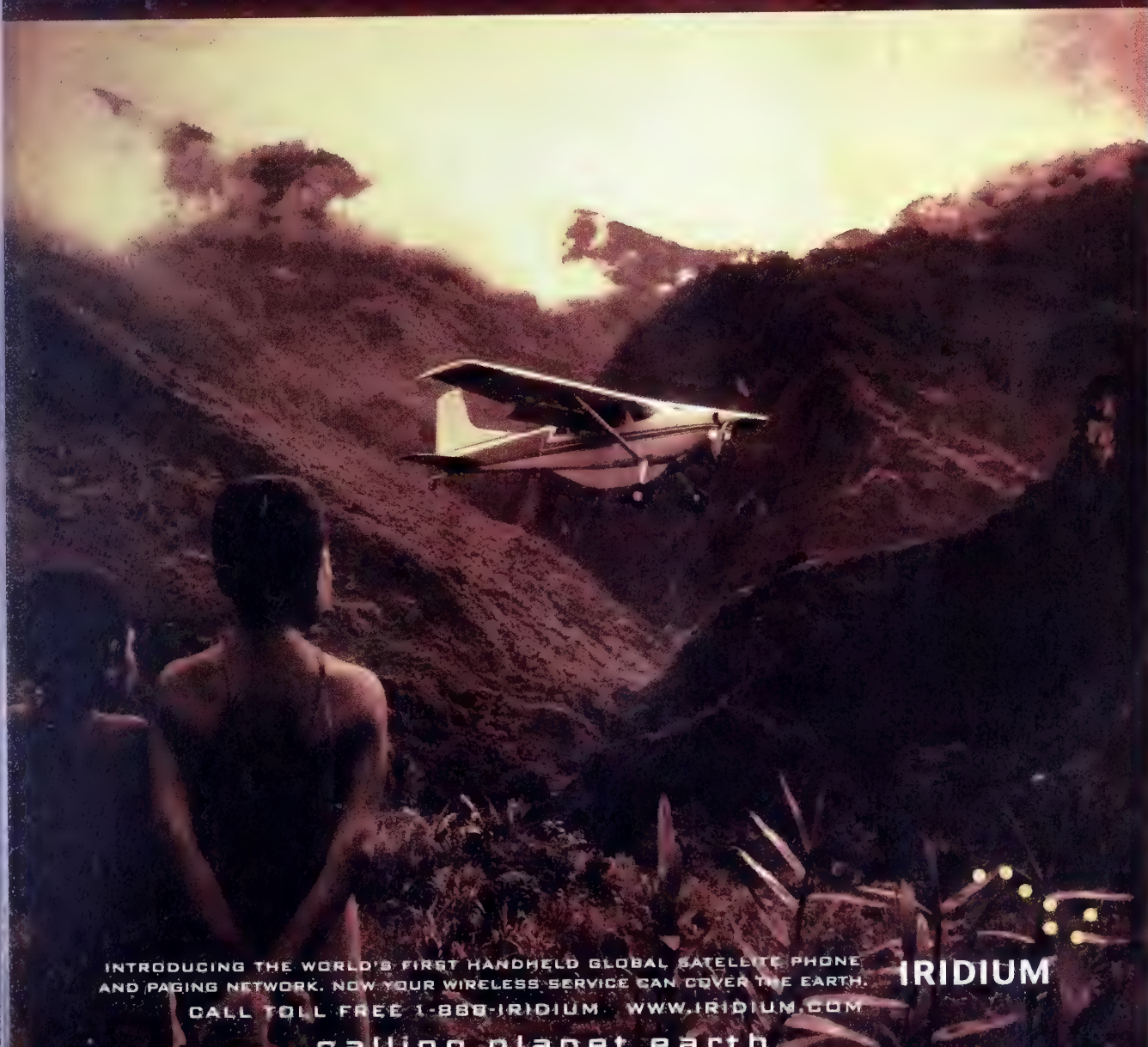
FUND	CASH POSITION	TOTAL RETURN*
BERGER SELECT	28.00%	24.30%
CLIPPER	40.00	0.20
FRANKLIN GROWTH I	33.40	-0.11
OPPENHEIMER GRTH.	30.00	-10.00

*Year to date, through Aug. 31.

DATA: MORNINGSTAR BUSINESS WEEK

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EERIE QUIET

After the market closes on Aug. 31, normally bustling Harry's was nearly empty

gage-backed bonds. So despite the rally in treasuries, the value of investment houses' bond inventories has fallen. "It will be very difficult for firms to make money in fixed income," says Salomon Smith Barney brokerage analyst Greg Moszkowski, who just cut his bid for prices for Merrill Lynch & Co. and Morgan Stanley Dean Witter by roughly 15%.

The industry's two biggest wether deals are also in question. A rumor is that the Travelers-Citicorp deal may fall through. Travelers' stock plummeted to \$44.50 a share from \$108 when the deal was announced on April 10, while Citicorp has dropped from \$180 to \$108. And the market correction could force Goldman, Sachs & Co. to postpone its IPO of part of the firm. Goldman, Travelers, and Citicorp say they have not changed their plans.

HE WHO HESITATES. Certainly, Goldman fiddled while Rome burned. After years of deliberation, the firm finally decided to go public in June. At the time, competitors Morgan Stanley Dean Witter and Merrill Lynch were trading at more than 3.5 times book value. But with today's lower valuations, Goldman's price tag drops from \$22 billion to \$17.4 billion, "reducing Goldman's IPO price to the take of Goldman partners," says Michael Flanagan, an analyst at Financial Service Analytics.

There are bright spots. Some 50% of Charles Schwab & Co.'s revenues come from mutual-fund fees, not to mention trading commissions. Chairman Charles R. Schwab expects trading volume to come down 15% to 30%, but even so "the third quarter is looking quite robust" for his firm, he says. The businesses should stay strong, too—some deals could fall apart. For example,

Proffitt's Inc. agreed to buy Saks Fifth Avenue stock, but now Saks can walk away since Proffitt's stock has fallen to \$23 a share, below the deal's collar of \$30.52. Proffitt says the deal will close in September.

It's unlikely that seven years will be followed by several lean ones. But contractors and car dealers beware.

By Leah Nathans Spira
New York, with bureau rep

WALL STREET RECORKS THE BUBBLY

After a seven-year securities-industry bonanza, the party's over

For almost seven straight years, Wall Street has been raking in the big bucks. Contractors from Connecticut to the Hamptons are scrambling to build handsome stone mansions, while New York-area car dealers can't keep enough BMW convertibles in stock to meet demand. All this courtesy of a cascade of fees and commissions. The question now: Is this party over?

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The answer is a resounding yes. The stock market's drop has crushed brokerage stocks, with the biggest firms down 25% to 45% from their 1998 highs. And many of Wall Street's biggest firms are more than 30% owned by employees. Driving those stocks down is the fear that more losses from Russia and other emerging markets may be announced.

Equally worrisome is that another Wall Street engine—the debt- and equity-underwriting markets—has ground to a halt in response to market volatility. Only one IPO has been launched since Aug. 24, and 10 were withdrawn in the past month, says analyst Randall Roth of the IPO Plus Aftermarket Fund. "There is underwriter rubbernecking. Everyone is stopping to look at the carnage," he says.

The result? Expect the securities industry to shift into retrenchment mode,

with cuts in bonuses and layoffs. "It's a reasonable thing to get prepared for a tough environment," says James Dimon, co-chief executive officer of Salomon Smith Barney, which just announced a \$150 million net loss from its Russian and emerging-markets businesses.

London will get hit first. "You won't see layoffs here for a bit because U.S. staffs are relatively lean," says headhunter Joan Zimmerman at G.Z. Stephens. Still, at 289,300, the securities industry's 1998 head count has passed its 1987 high of 260,000. As a harbinger of tough times in the U.S., local securities firms from Moscow to Jakarta are cutting jobs. Rumors are rife that Credit Suisse First Boston will shrink its 320-employee Moscow office.

Fears about Russian debt have already hurt prices in larger fixed-income markets, including corporate and mort-

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LEHMAN BROS.	42 1/2	85	-47
MERRILL LYNCH	67 1/2	107	-37
MORGAN STANLEY	59 1/2	96 1/2	-39
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TRAVELERS**	44 1/2	73	-39

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UP THE VOLGA WITHOUT A CALCULATOR

At this point, banks can't figure their exposure

The banks had to say something. As their share prices crumbled in response to Russia's default on Aug. 17, financial institutions around the world have scrambled to come up with numbers for their Russian losses. The revelations are substantial: Barclays Bank PLC, for one, said it took a \$418 million charge to cover Russian losses, while Republic New York Corp. said Russia wiped out a full quarter of earnings. But the news isn't nearly as earthshaking as the upheaval in the financial markets seemed to suggest. And that raises a question: Is that all there is?

In a word, no. Banks, investment houses, and hedge funds have yet to tell the full story of the emerging-markets rout. They might not even know it. Concerns are growing that Russia could default on hard-currency sovereign debt—\$17 billion in debt service falls due next year. There are also rumblings of good news, too, maybe in the form of a better deal for foreign buyers of ruble debt.

Cover Story

THE GLOBAL CRISIS

At this point, banks have surveyed their direct damage in Russia, and although their estimates use different assumptions, their numbers are probably in the ballpark, a senior federal regulator says. But there's still the possibility of a wild card—the blowup of a large leveraged derivative in some out-of-the-way place. Often, “banks really think they have the full exposure monitored—but don't realize the full exposure until several weeks after the crisis,” says Leslie Rahl, a partner at Capital Market Risk Advisors, a New York derivatives consultant. “I think it's going to get worse before it gets better.” And there are other forms of damage—from other emerging-market assets knocked down by jittery investors or from the closing of currency markets that once promised lu-

crative trading opportunities. Not only has trade pretty much stopped in the Russian ruble, it's also stopping in the Malaysian ringgit by government order.

New losses in Russia are surfacing almost daily—involving everyone from Nomura Securities in Japan to BankAmerica in the U.S. Almost none describe the damage in the same way. Chase Manhattan Corp. reported overall charge-offs of \$200 million for July and August. Citicorp reported \$200 million in Russia-related losses. Others have released estimates of trading losses—\$350 million at Bankers Trust and \$150 million net at Salomon Smith Barney, for example.

To be fair to the banks, the problems in valuation are staggering. Banks are trying to account for assets that no longer trade, denominated in a currency with no real market value. BT and Republic have marked down their Russian bonds to 15¢ on the dollar. But a federal regulator says other banks are using exchange-rate estimates from 30¢ on the dollar to zero. “People are using different ruble figures in coming up with the figures they are reporting because there is

HOW CURRENCY CONTAGION MIGHT SPREAD

- ▶ Russia defaults on its foreign debt and suspends payment on currency hedges
- ▶ A hedge fund manager who used Russian treasury bills as collateral to get financing to buy more Russian T-bills receives a margin call from his U.S. bank
- ▶ The hedge fund manager sells whatever possible—say, collateralized bonds in Latin America—to meet the call
- ▶ Forced selling by the hedge fund manager and other overleveraged investors helps depress the value of those bonds
- ▶ The hedge fund goes bust and the bank learns of another loan gone sour—and perhaps lower values for its holdings of emerging-market debt



no ruble,” says Jake Newman, director of Standard & Poor's Corp.

Just as perplexing is how to account for derivatives and hedge fund losses. Capital Market Risk Advisors estimates total Russian derivatives exposure could be \$65 billion. Much of the action involved Western investors swapping rubles for dollars to be repaid by Russian banks that are not paying their debts.

UNCLEAR. At least four hedge funds that invested in Russia have failed, says Nicola Meaden, president of T&F, which tracks the industry in London. Charles Gradante, a hedge fund consultant, says several managers removed their currency hedges before the ruble collapsed on the strength

of the International Monetary Fund's July loan to Russia.

Despite the disclosures last week, the size of many banks' troubles remains unclear. Billions of dollars in Latin American debt on banks' books tumbled in value, but it is unclear how much of that has been reflected in last week's announcements. Says Charles Peabody, banking analyst at Mitchell Securities, “There are further losses to be disclosed.” Indeed, Russia may be just the tip of the iceberg.

By Gary Silverman
in New York, with bureaus reports



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ASIA

THE WALLS ARE GOING UP ALL OVER ASIA

Country after country retreats from the global economy

The Asian crisis is entering a new stage when beleaguered nations erect walls between themselves and the dangerous forces of world markets. Malaysia Prime Minister Mahathir Mohamad imposes sweeping capital controls, fixes the exchange rate—and sacks his reformist Deputy Prime Minister. The Hong Kong government pumps \$12 billion into its stock market to foil speculators. Taiwanese officials make it more expensive to short stocks. South Korea cancels the sale of Kia Motors Corp. rather than accept low but realistic bids for the bankrupt carmaker. And Japan refuses to let its biggest banks fail.

Cover Story

THE GLOBAL CRISIS

These are just the kind of moves that U.S. and International Monetary Fund officials deplore. They signal a retreat from the global economy and a collective repudiation of the Western doctrine that only deep structural reform and a total commitment to free markets can provide a way out of Asia's mess. But after seeing their currencies pounded by spec-

ulators and their real economies grind to a halt, Asian leaders are fed up with globalist thinking. Never mind that the region's rotten banks created the crisis in the first place. Right now, all the Asians feel is the pain of high interest rates, record bankruptcies, and rising social tension. Reform sounds good in principle, but recovery—even survival—comes first. To their credit, the Indonesians and Thais still seem to be pressing ahead with reforms. But other nations are signalling they will go for growth and emergency bailouts, no matter what the long-term cost.

BANK HOLIDAY. Japan is the most important player in this drama. The Japanese had been making noises about a tough cleanup of the banks. But in the last few weeks, the tune has changed. Those backing a radical bank overhaul are "amateurs," says Finance Minister Kiichi Miyazawa, and they have no idea what chaos will ensue. Nomura Research Institute economist Richard Koo concurs: Japan's banking woes run so deep that a heavy-handed workout would set off a chain reaction of bank failures and corporate bankruptcies that would cripple Japan. "If you close down

INVESTOR, BEWARE

Only the banks and Tokyo know how much bad debt is hobbling the Japanese economy

the banks, you also kill a lot of good borrowers," he warns. Already, the failure in November of Hokkaido Takushoku Bank Ltd. has done grievous economic harm to Japan's northern island.

So Prime Minister Keizo Obuchi and the ruling Liberal Democratic Party are trying a variation of the old convoy system. Regulators will not force any more big banks to shut, however much they deserve that fate. A rapid sell-off of loans at cut-rate prices doesn't seem in the cards. It would force too many mass

write-offs too fast. Instead, the government will merge weak banks with strong ones, unwind bad loans slowly, and use taxpayers' money to refloat the system. Hence, the frantic efforts of the LDP to stage-manage a merger between the ailing Long Term Credit Bank of Japan and a healthy Sumitomo Trust & Banking.

The big question is whether this soft-landing approach will be too soft. The government's current "total plan" to set aside \$214 billion to protect deposits and shore up banks could just keep the whole rickety structure in place. Politically favored borrowers may end up getting new credits regardless of the viability of their businesses. Not surprisingly, Japan is interested in telling global investors the true level of bad debt. None of this constitutes a strong sign to global investors that Japan will get back on track fast.

Yet the Asians have fallen so far from grace that it's easy to sympathize with their position. Even the Thais, who have tried to play by the IMF's rules, think there is something amiss with speculators can cause such havoc. They sympathize with Hong Kong, which has been a model of free trade and is now under attack just because every other place is under attack," says Thai Deputy Finance Minister Pisit Leeahtam. "Many Asians think Mahathir has a point when he states that controls are the only way to keep badly needed capital in the country. For Asia, the temptation to opt out of the international economy is starting to look a lot more attractive than anybody in the West realizes."

By Brian Bremner in Tokyo
Mark Clifford in Hong Kong



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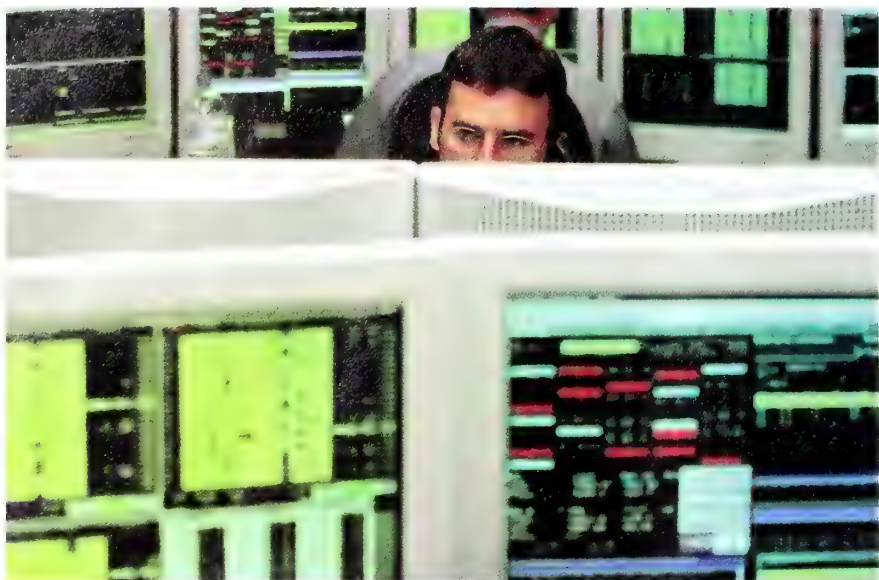
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FOR EMERGING MARKETS, 'PURE CARNAGE'

And for market makers, a major shakeup seems almost certain

If you want to check the pulse of the emerging-markets securities business, Merrill Lynch & Co.'s trading desk in London is a good place to start. There, Robert A. Butler, an angular, 34-year-old Scot, presides over the trading in "emerging Europe" stocks. Ever since Moscow defaulted on its debt on Aug. 17, Butler and his colleagues on the desk have been run ragged helping clients dump once fashionable Russian stocks

changed. Before the recent battering, Butler had been taking orders from big clients such as mutual funds and pension managers, which wanted stakes in what seemed one of the great emerging markets. But recently, such former enthusiasts, as well as hedge funds scrambling to meet margin calls, have been selling at just about any price.

Butler and other emerging-markets pros have few illusions about the future of their industry. Since just about every emerging economy from Thailand to Venezuela has taken a drubbing, a major shakeup of the business seems to be in the cards. ING Barings Ltd., once one of the biggest emerging markets players, announced some 250 layoffs in emerging-markets earlier this year and just vowed to reduce costs by a further 25%. "Every financial institution is going to take a close look at how they want to conduct their business," says Marcus

A. L. Everard, head of the emerging-markets client business at Credit Suisse First Boston Corp. A pioneer in Russian investment banking, CSFB admits to a \$254 million cut in profits thanks to Russian turmoil, and Everard acknowledges this could widen if markets sag further.

Of course, investors have also taken big

WRECKAGE

Many funds have lost more than 50% of their value over the past year

hits. Long-Capital Management, the billion hedge managed former Salo Brothers Vice-Chair John Meriwether lost 44% of a

in August. At least four hedge funds heavily invested in Russia have filed Chapter 11 bankruptcy protection according to Nicola Meaden, president, TASS Management Ltd., which tracks industry in London. Three of those, \$180 million to \$200 million in capital were managed by McGinnis Advisors San Antonio. "We were not aware we had this kind of [default] risk cause it is unprecedented," says David McGinnis, the company's president.

NO RETURN? With many emerging-markets funds down 50% or more in the 12 months, investors are certainly on edge about the dangers now. One of the most respected hands in the business, Peter R. Geraghty, former head of emerging markets at ING Barings, says if burned investors will come back as quickly as they did after Mexico's financial collapse in 1994-95 rocked the world's smaller markets. "There's a fundamental disappointment with performance," he says.

For one thing, in recent years, about every small market from Egypt to Zimbabwe has been hawked to investors, so firms won't be able to rely on novelty to hype securities. Even if investors do return, they may commit money and stick to the bigger markets such as Brazil and Hong Kong, Geraghty reckons. He also bets that with so many companies in financial trouble, private equity and bonds may turn out to be the way the emerging-markets game is played, eclipsing investing in stocks. He is about to go to work building a bond portfolio for Washington-based Darby Overseas Investments Ltd., the emerging-markets firm headed by former U.S. Treasury Secretary Nicholas F. Brady.

Having endured the chaos of the

few weeks, it is too soon for traders to believe investors will come trooping back. "You should people up," Butler says. "Lukoil when IBM is much cheaper than a few weeks ago?" Butler. It is a question that any company or country scrambling for capital is going to have to answer.

By Stanley Lee
in London

Cover Story

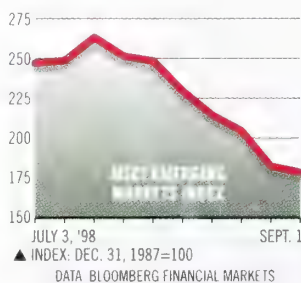
THE GLOBAL CRISIS

such as energy giant Lukoil and Mosen-ergo, the big utility. At the same time, the Polish and Hungarian stocks that Butler's desk trades have been beaten to a pulp. "We have seen two weeks of pure carnage," he says.

By Sept. 1, the frantic trading has subsided, giving Butler time to survey the wreckage. It is not a pretty sight. The Russian index is down more than 50% in the past month to a record low, while Poland and Hungary are not much better off. Trading in Moscow is almost dead. On one recent day, a single trade worth \$37,000 went through the Russian trading system during the usually frenetic opening hour.

Merrill and other offshore market makers are still open for business. On Sept. 1, Merrill did \$15 million to \$20 million in Russian stock trading—a decent day's work. But the business has

TRACKING THE MELTDOWN



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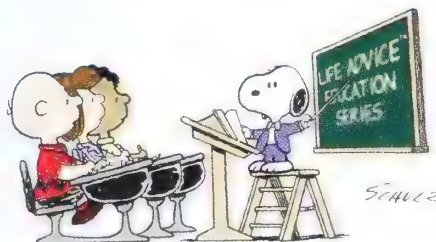


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BIG BLUE SHOULD GET A LITTLE SMALLER

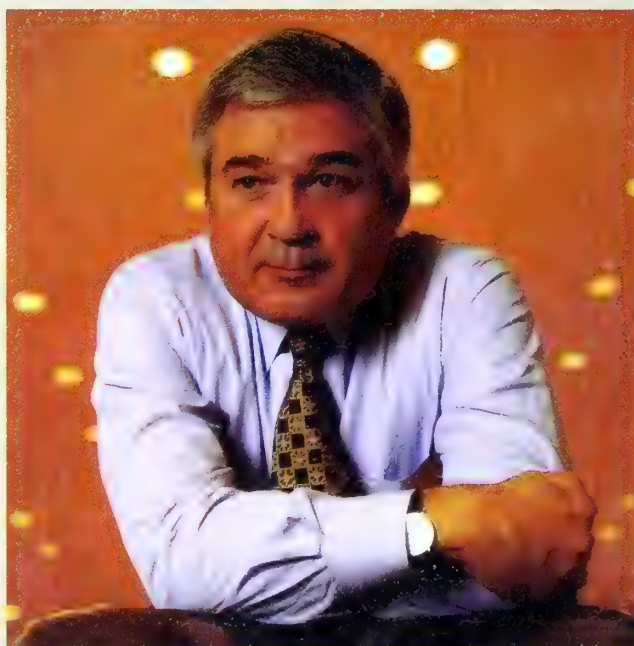
COMMENTARY

By Ira Sager

Big Blue is doing a bit of reshaping, and it's about time. Word leaked out on Sept. 1 that IBM has put its Global Network operation up for sale, hoping to bring in \$3 billion to \$4 billion from the unit that handles data communications traffic for customers in 900 cities around the world. It's the second business IBM execs have put on the block since April. That month, the company started shopping around a division that makes printers, looking to fetch \$2.5 billion.

These are smart moves, but IBM should think about more. The company has too many businesses that are laggards or that simply no longer make sense for IBM to own. Should IBM be selling educational software to consumers? The answer is no, because it lacks a strong consumer brand—either in hardware or in software. The same can be said of other parts of the business where the IBM brand has faded, including networking gear, desktop computers, and Unix software—to name a few operations that should either go or be dramatically scaled back. IBM declined to discuss its plans.

OVERCAUTIOUS. The fact is, these are not realms that will make IBM a success in the Internet Age. The giant could easily shed 10% of its heft, raising some \$8 billion, if it sold its noncore businesses. It should take the money—and the resources that could be freed up—and pour them into core areas, such as software and services to facilitate electronic commerce and other Web-based systems for corporate clients. A few years ago, CEO Louis V.



Rethinking IBM

GLOBAL NETWORK Now is the time to sell this worldwide data network, which IBM spends about \$200 million a year to maintain. Telecommunications companies can provide the service cheaper than IBM.

PRINTERS A few years ago, the computer giant flirted with selling this operation, but the asking price was too high. Price it to sell this time, and move on.

PERSONAL COMPUTERS The company's history in PCs has been one long roller-coaster ride. Resell a commodity product from another supplier.

NETWORKING PRODUCTS Products from Cisco and 3Com rule. IBM is left to produce esoteric communications gear for its proprietary machines. Sell.

UNIX COMPUTERS Get what you can for the Unix workstation business. Stop investing in the IBM flavor of Unix software and resell Sun Microsystems' version.

Gerstner Jr. appeared to be ready to do just that, making bold moves to acquire software companies Lotus Development Corp. and Tivoli Systems. But lately, the pace of major acquisitions has slowed. "They have become highly risk-averse," says Howard Anderson, presi-

dent of market research firm Gartner Group. Gerstner "is doing the thing like a dual fund."

IBM doesn't need a restructuring plan. But it does need an aggressive price-cutting plan. Despite doing a stunning job of curbing costs and boosting earnings to double-digit growth, Gerstner hasn't done much to pump up the top line. The computer giant's revenue hit \$78.5 billion, a piddling bump over 1996. Sales in the first six months of 1997 were flat.

That's why it's time to think some businesses. Sell the personal computers. Sell the View Financial Group.

GERRSTNER: Time to focus on IBM's core strengths

Gary Helmig figures the latest misstep in that business—building too many machines during the holiday season—cost the company \$1.3 billion in revenue so far this year. Because resellers have been counting machines to clear excess inventory. And ranking within the top suppliers of PCs worldwide, IBM's profitability has been spotty. The company lost \$100 million in PCs last year.

IBM doesn't have to be completely out of PCs. It can let someone else manufacture them for IBM to resell. The company is already doing with a few. The savings in development and manufacturing costs

could boost earnings. Then the company can focus on staying ahead in the areas where it is a world-class competitor. Cause the innards of those machines still require a lot of proprietary technology—something IBM has at. The company can also invest

in its PC server business, an IBM badly needs to catch up Computer Corp. by bringing class reliability and services.

se should go? IBM's Unix soft-workstation businesses. The Unix workstation business lat for years. "IBM should give s Forrester Research analyst t Woodring. He suggests that Sun Microsystems Inc.'s So-on of the Unix operating sys-e it is much more popular are developers, especially ners.

area from which IBM needs to rganized retreat: networking . This \$2 billion operation teric communications gear, IBM machines. Long ago, the giant was eclipsed in this sec-working upstarts such as Cisco nc. and 3Com Corp. "That s really atrophying," says v's Helmig. Big Blue can't s customers who rely on the , but it could sell the business nization that would promise to ose customers. Meanwhile, IBM centrate on building network-are and software that's more the World Wide Web.

XPERTISE. For years, IBM exe-c claimed that the company's folio of businesses—everything computer memory chips to airframe computers—is a . When one part of the business , the argument goes, other make up the difference. ating computing like a bal-k portfolio is the wrong ap-m's greatest strength is its provide the high-tech services complex computer jobs. That's ompany routinely wins the ourcing deals. On Sept. 2, Big awarded a \$3 billion, 10-year o maintain Cable & Wireless ations' computer network

r has a chance to reinvent the ggest computer company. So far, ackled the job. IBM has some g businesses—particularly in services, a \$19 billion operation wing by 22% a year. Overall, BM might have a better chance it unloaded more of its lack-inesses.

te editor Sager covers IBM and ter industry.



SHAKEUPS

CAN A NEW CREW BUOY BOEING?

Investors like the shuffle, but the problems are still serious

The management shakeup announced on Sept. 1 by Boeing Co. brings in a fresh team—but won't cure the company's ills overnight. After Boeing put new executives in charge of its major business units, including the troubled commercial-airplane group, its stock climbed nearly 7% on the news, to 33%. But "no matter what you think of the new team, they face exactly the same problems," says Joseph F. Campbell Jr., an analyst at Lehman Brothers Inc.

The world's No. 1 aerospace company has been beset by bad news for the past year. Cost overruns and production snafus contributed to a \$178 million loss in 1997—the company's first in 50 years. And the economic crisis in Asia, a region responsible for one-third of Boeing's business, is slowing aircraft orders. Analysts don't expect a significant earnings recovery until 2000.

"IMPRESSED." On Aug. 30, Boeing's top brass struck back. CEO Philip M. Condit decided to push Ronald B. Woodard, 55, head of the commercial group, out of his job and shuffled managers across Boeing. Only a few months ago, Condit had vowed not to make Woodard a scapegoat. But unexpected cost overruns at the company's Wichita airplane plant were the final straw, say sources. The board approved the plan on Aug. 31. "It's about time," says Bill Whitlow, an investment manager for Safeco Northwest Fund, which holds 2 million Boeing shares.

The new president for commercial aircraft is Alan R. Mulally, 53, Condit's

SEATTLE SQUEEZE: Boeing must cut millions from the cost of each plane

right-hand man in the development of the successful 777 aircraft and most recently head of Boeing's profitable defense and space unit. While Woodard was known as a master salesman with a sometimes imperious manner, Mulally is a gregarious manager with deep roots in engineering and production. The day after his promotion, he called Bill Johnson, district leader of the machinists union, to reassure him about the future. "I was impressed," Johnson says.

CHAOTIC SYSTEMS. Such goodwill could help him fix Boeing's nagging manufacturing problems. Even as the company aims to increase output to a record 51 planes per month by the first quarter of 1999, it has to cut millions from the cost of each plane to boost earnings. Net margins this year are expected to be a paltry 1.7%, projects analyst Peter Aseritis of Credit Suisse First Boston. He expects them to double, to 3.4%, next year, but that's still far below the 10% Wall Street thinks Boeing should command. Numbers like that have helped drive Boeing stock down 44% from its historic high of 60% in July, 1997.

A tougher challenge will be improving Boeing's chaotic information systems. The company's internal controls are so fouled up, say analysts, that Boeing has repeatedly misguided them about expected earnings. For now, that problem falls on Chief Operating Officer Harry C. Stonecipher, who is acting as chief financial officer until a replacement is found for Boyd E. Givan, who retired as CFO on Sept. 1.

The new team needs to build a track record. And Condit—whose job is probably on the line, according to analysts—"has bought himself another year," says a senior exec for a U.S. airline. If Mulally does well, he could save Condit—and some day even succeed him.

By Andy Reinhardt in San Mateo, Calif., and Seanna Browder in Seattle



HAPPY DAYS
Kimmons and Canion were all smiles until the Compaq co-founder suddenly quit GK in August

utives than it did developing new technology or even doing research and development. Opening doors four years ago, GK made grand promises of developing new technology for individually customized training systems. But it shifted gears so often it never

EXECUTIVE SUITE

IS SOMETHING FISHY AT GK INTELLIGENT?

The software maker has zero products—but sky-high salaries

Even as recently as Aug. 3, Compaq Computer co-founder Joseph "Rod" Canion couldn't say enough good things about GK Intelligent Systems Inc., the Houston software developer he joined as chairman in April. Canion had purchased 12% of the company and quickly began lining up a team of top-notch managers. The goal: create Web-based training systems with "artificial intelligence" that adapt training to the way individuals learn. "This is change-the-world stuff," he told BUSINESS WEEK back then.

Maybe not. Canion abruptly fled GK Intelligent on Aug. 12, leaving behind unexercised options then valued at \$10 million and a trail of unanswered questions. The six execs Canion hand-picked to manage the growth he had predicted also bolted. What happened? BUSINESS WEEK has learned Canion's resignation came shortly after J. David Cabello, who joined the firm as general counsel on July 29, raised questions about whether all of GK's

stock sales complied with Securities & Exchange Commission regulations governing such sales. A few days later, Cabello also left the company. And on Sept. 1, GK disclosed it had hired an outside law firm to investigate "possible securities law violations" and delayed release of its financial statement for the fiscal year ended May 31. GK Chief Executive Gary F. Kimmons declined to answer written questions from BUSINESS WEEK about GK.

A BUSINESS WEEK review of public documents paints a picture of a company that may have spent more time issuing and selling stock and enriching its exec-

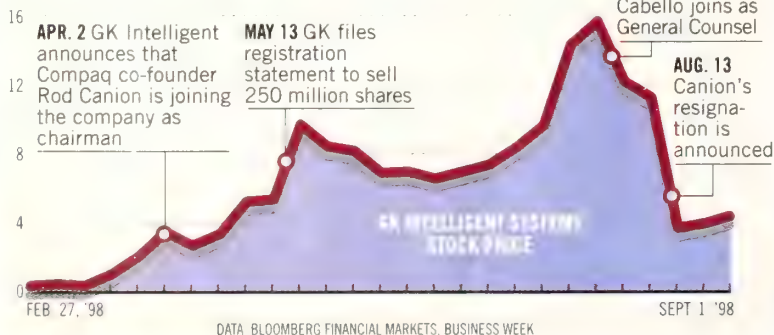
er finished any. First, GK started out to build a training system for the energy industry but abandoned that project after a dispute over payment with its partner, AT&T Global Information Systems, now NCR Corp. NCR Director of Intelligent Systems Bob Simpson says the payment dispute "was one of the problems that led NCR to end its involvement."

HEFTY COMPENSATION. Next, GK planned a training system to teach IBM programmers. That, too, was abandoned after IBM withdrew from the project, says GK Vice-President Rodney L. Norvick. IBM says it can find no evidence that such a deal existed. And in February, GK formally announced an Internet training program for businesses and consumers. But release of that program has been delayed, GK now says.

What was GK doing? Through much of that time, the company was selling millions of dollars in stock. In the fiscal year ended May 31, 1996, sales of stock warrants for shares raised \$904,000. In the following fiscal year, GK raked in \$1.1 million.

In two separate sales since Canion joined this year, the company raised \$6.6 million. In total, GK has sold about 10 million shares of stock, according to SEC documents, raising roughly \$13.4 million. In May, the stock approached a record price of 7 1/2, but the company filed a registration statement saying it would issue 250 million shares. This would increase the number

CANION'S SHORT-LIVED REIGN AT GK

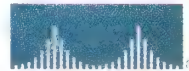


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outstanding shares tenfold. In the days since Canion's departure the stock has plunged.

At least for the past two years, nearly as much money as was raised from stock sales was paid out in hefty compensation to the CEO and other top executives, according to government filings. In the fiscal years ended May, 1996, and May, 1997, \$2.9 million was raised in stock sales and \$2.8 million was paid to Kimmons, former vice-chairman Joseph D. Ben-Dak, and others. During those same two years, the company's annual reports say spending on R&D never reached \$60,000.

CLOSE TIES. Some of GK's shares ended up in the hands of Graystone Financial Services Inc., a company controlled by Thomas V. Ackerly, a New Jersey resident who in 1990 was fined \$1.3 million, censured, and barred from associating with the National Association of Securities Dealers for manipulating the shares of another company. Since 1997, Graystone has sold 200,000 shares of GK, according to SEC filings. In December, Graystone changed its name and moved to offices less than a mile from GK, according to an SEC filing.

But even without the physical closeness, Graystone has ties to GK through the tech company's former Vice-Chairman Ben-Dak, who—according to SEC filings—was simultaneously a director of Graystone and of GK. Ben-Dak disputes these filings. The 56-year-old Israeli citizen, who describes himself as an expert in international technology transfer, admits knowing and advising Ackerly but insists he never was a director of Graystone. "I've never participated in any board meetings," he says. "I've never signed anything [accepting a seat]." Ackerly could not be reached for comment. Phone numbers listed on SEC filings for Graystone and successor GS Financial Services Inc. do not reach the company.

Was Canion bothered by GK's past and present? He declined repeated requests for interviews. But it was clear that he was not happy with at least some of what he saw when he first arrived. Both he and GK director Jerry Allen, who joined in April, insisted on buying out Ben-Dak's shares before making separate investments, says Allen. "We did see a need to get him out," he says. "We wanted to know what he had done for the company. In our view, it was not substantial." But certainly, given his hasty retreat, Canion probably wishes now that he had asked more questions.

By Gary McWilliams in Houston

INDUSTRIES

THOSE #!*&#! JET SKIS ROAR UP THE POTOMAC

Personal watercraft makers take their case to Congress

On Aug. 25, the Beltway buzz turned into the mosquito-like whine of engines on the Potomac River. Congressional staffers and agency officials happily carved turns astride a fleet of so-called personal watercraft, better known by their Kawasaki trade name—jet skis. "I'd never ridden one before. It was a lot of fun," enthused one legislative aide.

Free ride? Not exactly. The jet-ski manufacturers that hosted the outing want something from these aides' bosses: protection from a federal agency. This month, the National Park Service will seek comment on a proposed regulation to ban the use of jet skis in some national parks and potentially limit the noisy craft in others. The manufacturers hope to persuade Congress to press the Park Service to water down the restrictions. And that's not the only trouble the watercraft manufacturers are in. The Park Service will join a range of bodies—from the San Francisco Board of Supervisors to the North Carolina Assembly—calling for the banning or reining in of what opponents consider waterway terrors that are noisy, polluting, and dangerous.

LIFE-THREATENING? Take Lawrence A. Geiger of Merritt Island, Fla. He says that his Boy Scout troop was "threatened with our very lives" by aggressive jet skiers during a recent canoe trip on the Oklawaha River. State statistics show that these water scooters account for 30% to 55% of boating accidents, even though they represent only 4% to 13% of powercraft in use. In part because of this criticism, the industry has seen its sales slump by 25% since 1995.

But it's not just a fight between busi-

ness and granola-chewing lily-pad lovers and Boy Scouts. Irwin L. Jacobs, chairman of Genmar Holdings Inc., the world's biggest private boatmaker, yanked his company out of the National Marine Manufacturers Assn. in 1996 over what he called the group's promotion of jet skiing while neglecting

the interests of fishermen and boaters. "I'm not going to help them build a business that abuses our customers and defies everything we stand for," he fumes.

Unfair, jet-ski makers retort. True, they say, there are some irresponsible riders who have taken to heart the attitude proclaimed in one industry that "Scenery is for saps." But penalizing all users because of the bad apples is "like forcing all Buicks to drive



DANGEROUS NUISANCE?

Now "water motorcycles" face curbs by the U.S. Park Service

at 45 mph because you caught on speeding," argues Kawasaki spokesman Roger Hagie. Besides, companies such as market leader Bombardier Inc. are trying to jump-start sales by developing quieter, less-polluting machines. They also are pushing for legislation setting rider age minimums and requiring better boating education. And their congressional wooing has not been in vain. Senator Slade Gorton (R-Wash.), for instance, recently took their side against suggested restrictions in Olympic National Park.

Still, the industry believes that the best argument for jet skis may be to experience itself. "Once you get people on it, they understand a little better what it's all about," says John Donaldson, head of the Personal Watercraft Industry Assn. But then, some of them may never really comprehend the special delight of riding a motorcycle on water.

By John Carey in Washington

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In Business This Week

EDITED BY KELLEY HOLLAND

JUSTICE DOES A MICROSOFT SWITCH

AFTER MONTHS OF LOSING ON legal and public-relations fronts to Microsoft, the Justice Dept. is trying to regain momentum in its antitrust case against the company as its Sept. 23 trial date approaches. Last June, a federal appeals court dealt a huge blow to Justice's case by finding that companies have a right to design products as they wish. That hurt the government's strongest line of attack—that Microsoft illegally tied its Internet Explorer browser to the Windows 98 operating system. Now, Justice is making a bold stab to rescue its case. On Sept. 1, it signaled in court papers that it's shifting its emphasis to a

monopolization case. Chairman Bill Gates, it alleges, was involved in efforts to pressure rivals to stop or delay marketing new technologies. Microsoft denies it. Experts question whether Justice can succeed with a new strategy at this late date.

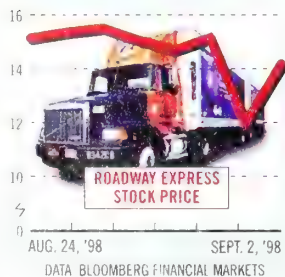
COSTLY GHOST AT NORTHEAST

NUCLEAR POWER CONTINUES to haunt Northeast Utilities. A Federal Energy Regulatory Commission administrative law judge ruled on Sept. 1 that there was mismanagement at the company's 49%-owned Connecticut Yankee nuke, shut since 1996. If the finding is upheld, analysts say Northeast would be forced to pay about \$100 million in decommissioning costs itself. Northeast had wanted to pass much of the tab on to ratepayers.

CLOSING BELL

HARD TO CARRY

Strikes giveth, and strikes taketh away. In 1997's third quarter, the strike at United Parcel Service gave Roadway Express an extra \$25 million in revenues, boosting its earnings to 50¢ a share. Then came the GM strike this summer. Akron-based Roadway, the country's No. 2 express trucker and a big carrier of GM parts, suffered. On Sept. 1, Roadway said the strike will help push third-quarter earnings down 60%. That sent the stock down, to 12 from 15%, as the market rose 288 points. But it recovered some the next day.



KILLING WEEDS GETS CHEAPER

GOOD NEWS FOR AMERICAN farmers. On Sept. 1, Monsanto said it was cutting the price of its Roundup herbicide by 16% to 22%. HSBC Securities analyst Paul Leming says Monsanto is trying to build up sales of Roundup ahead of the expiration of its U.S. patent in 2000. Monsanto also announced it was raising fees paid by farmers who use its Roundup Ready soybeans, engineered to tolerate Roundup herbicides. The next day, DuPont announced a deal for exclusive rights to sell an FMC herbicide for soybean crops in the U.S.

CUTTING THE RISK OF BREAST CANCER

THE FIRST TREATMENT FOR reducing breast cancer risk is moving closer to approval.

JOHN PEPPER

PROCTER'S LATEST GAMBLE

Procter & Gamble is behind on Chairman and CEO John Pepper's plan to double sales to \$70 billion by 2005. In the year ended June 30, revenue rose 4%, to \$37.2 billion, from \$35.8 billion.

So, to keep his plan on track, Pepper said on Sept. 1 that P&G will reorganize its businesses along product lines rather than geographical boundaries. Details won't be available for several weeks, but some corporate staff will be cut.

While Procter's sales are nothing to sniff at, the consumer-products powerhouse has been beset by

myriad woes. There's the flu in Asia, where P&G gets 12% of its revenues, turmoil in Russia and Latin America, and the strong dollar.

Pepper hopes to boost emerging markets sales by \$8 billion over the next decade, while sales from core businesses rise \$15 billion and sales of new products such as fat substitute Olestra rise \$12 billion. Analysts are pleased "The plan is strategically sound," says Andrew Shore of PaineWebber. "Do you need 20 or 40 brand managers around the world for one product? No."

By Peter Galuski

On Sept. 2, a Food & Drug Administration committee recommended approving Zeneca's tamoxifen citrate for women at high risk of developing breast cancer. The drug has long been used to treat breast cancer. But studies suggest it may reduce some women's chances of getting the disease too. Still, the drug carries such risks as higher incidence of endometrial cancer and blood clots. Such a medicine "should be used on an individual basis considering the risk/benefit ratio," says Dr. Marianne Legato, a professor at Columbia University College of Physicians & Surgeons.

BEN & JERRY MAKE AN UNLIKELY PAL

ICE CREAM IS A COLD BUSINESS, as Ben & Jerry's Homemade knows well. The funky flavormeister on Sept. 1 was forced to strike a distribution

deal with archrival Häagen-Dazs, the only other national distributor besides Dreyer's Grand Ice Cream—which Ben & Jerry's is lining its business. In February, Dreyer's, longtime partner of B&J, made a play for Vermont ice cream company co-founders Ben Cohen and Jerry Greenfield would part with their combined stake. The company plan use Häagen-Dazs for delivery only. But analysts were stunned by the move.

ET CETERA...

- Northwest Airlines, in fifth day of a strike, loughed 27,500 workers.
- United is starting nonstop service between Chicago and Buenos Aires.
- AMP hired investment bankers to advise its AlliedSignal's offer.
- US Airways announced will repurchase up to 5 million shares.



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EDITED BY OWEN ULLMANN

Gore Is Beginning To Feel Clinton's Pain

Bill Clinton may be on the hottest seat in America these days, but Al Gore is the one who's sweating. Sure, the President is under siege over the Monica Lewinsky scandal, and a global slump has his economic nirvana at risk. But hey, he's not running for office again. Meanwhile, the Justice Dept. is examining Gore's role as a 1996 campaign fundraiser, and he no longer looks as though he'll be taking an express train to the 2000 Democratic Presidential nomination.

But unlike Vice-President George Bush, who laid low in 1987 amid Reagan Administration scandals and a stock market crash, Gore is embarking on an aggressive survival strategy to boost his fortunes. He's raising his profile with a series of public events on topics ranging from children's health to environmental protection. He's underscoring his role as a key adviser on foreign crises such as the turmoil in Russia. And to cement his relations with the party faithful, Gore is raising tons of money and stumping for Democratic candidates from coast to coast.

While building up chits with friends, Gore is also courting critics. Many business execs view him as an environmental extremist, so his staff is lining up private meetings with CEOs and drafting speeches that stress his belief in the promise of a high-tech economy. Not very sexy. But that's precisely the point at a time when Washington is obsessed by a sordid scandal. "The more the focus is on issues, the better it is for the Vice-President," says one Gore adviser.

ENCOURAGING POLL. Despite all the careful planning, Gore faces several crucial threats beyond his control. The paramount one: the economy. If the meltdowns in Russia and Asia trigger a recession, the booming U.S. economy and the first federal budget surplus in three decades—the Clinton-Gore team's proudest accomplishments—would be wiped out.

A Clinton collapse following the release of Independent

Counsel Kenneth W. Starr's report to Congress could also Gore in political jeopardy. "For better or for worse, Gore lashed to the mast of this Administration and rises or falls with it," says a veteran Democratic consultant. "If the President is at 35% job approval rather than 65% when we go into the primaries, then Gore is in trouble." That's not lost on Gore's brain trust. "If this became a problem for all Democrats, it would be a problem for him," concedes Gore consultant Robert D. Squier. "But I don't see it."



SOLIDARITY has its price

WILL SHE? In fact, so far Gore seems unscathed by the scandal. An Aug. 21-23 CNN/USA Today/Gallup Poll indicated that 63% of Americans found Gore "honest and trustworthy" while just 31% would say the same of Clinton. Still, four recent national polls show Gore trailing Texas Governor George W. Bush in a hypothetical 2000 match-up. And the smelly blood has emboldened potential Democratic challengers, including House Minority Leader Richard A. Gephardt of Missouri, Senators Kerrey of Nebraska, John Kerry of Massachusetts, Paul Wellstone of Minnesota, and former New Jersey Senator Bill Bradley.

Gore's Presidential prospects will dim if Attorney General Janet Reno seeks an Independent Counsel to investigate the Veep's campaign fund-raising. Any probe almost certainly would drag into the 2000 campaign and thus become a valued Gore asset: his Boy Scout image.

Gore's advisers are confident that their man's staid reputation will enable him to ride out any political storm. "In balance, he profits from whatever extra attention he receives," says Chief of Staff Ronald A. Klain. Maybe. But the economy tanks—or Clinton's popularity plummets—Gore's methodical survival strategy may not be enough to save him from the undertow.

By Richard S. Dunne

CAPITAL WRAPUP

TIME FOR A TAX CUT?

► A weakened President Clinton and sagging stocks are boosting the odds of a modest tax cut this year. Capitol Hill lawmakers are likely to provide tax relief of about \$75 billion over five years. That's far less than the 11-year, \$1 trillion cut House Speaker Newt Gingrich promoted just two months ago. But it's enough to give the GOP a strong campaign issue for November and put a little extra cash in the pockets of consumers spooked by Wall Street's gyrations.

Democrats are now expected to back a small tax cut. Clinton had opposed one, saying Social Security should be bolstered first. But that was before all the flak over lying about his relationship with Monica Lewinsky. Worried about handing Republicans more ammo, he has told top aides to quietly canvass Hill Democratic strategists for counterproposals to GOP tax breaks.

Republican congressional leaders plan to get together on Sept. 9 to draft the outline of a bill. It's expected to include a narrowing of the "marriage penalty" that forces some two-

earner couples to pay higher taxes than they would as singles. The bill may also include relief for farmers, working seniors on Social Security, small-business owners who buy health insurance. Corporations will likely get little beyond an extension of the tax credit for research and development.

Gingrich is still pushing a capital-gains tax cut. But other Republicans want to scuttle that idea, fearing it will trigger Democratic charges that the GOP is pandering to the rich.

By Howard Gleckman
and Amy Bon

COMMENTARY

By David Leonhardt

AT NORTHWEST, AN ESOP IN NAME ONLY

When Northwest Airlines Inc. stayed off bankruptcy in 1993 by selling a third of the company to employees, both sides hailed the pact as the start of a new relationship between workers and managers. "Airline historians," predict Northwest's top spokesman, "will probably record the events of the next year as the metamorphosis of a company and perhaps an industry."

Well, not quite. Today, Northwest's labor relations are the industry's worst. Its pilots struck on Aug. 29, and neither side seems in a hurry to settle. Even if they do soon, the unrest is likely to lead to the mechanic, who rejected a tentative pact on Aug.

Flight attendants may not be far behind. Still, don't blame employee stock ownership plans for Northwest's woes. Northwest's experience shows, by conspicuous

sense, what ESOPs need to be successful: genuine employee input into corporate decisions. Only by coupling financial stake with worker involvement can employee ownership deliver on its promise. "An ESOP raises expectations that need to be met,"

says Corey Rosen, executive director of the National Center for Employee Ownership. Otherwise, "you can use the company to perform worse and cause people feel manipulated."

ORTCHANGED. Where did Northwest's ESOP go wrong? For starters, the stakes of many of its employees don't vary with the stock price.

Northwest was a private company in 1983, and the \$900 million that 39,000 employees gave in concessions was much a loan as a true piece of the company. Only the pilots—whose large salaries allow them to take more risk—converted their take to common stock when Northwest went public in 1994. Most flight attendants and machinists didn't follow suit.

They can still do so—but at a conversion rate 50% below the pilots'. The rest will be paid back their concessions in 2003. Their prospects remain the same whether Northwest stock trades at \$60, as it did in March, or at today's \$28.

Even the pilots feel shortchanged. Sure, they have sold 40% of their stock so far at a gain of \$117 million.



But that goes into their retirement accounts, while top Northwest executives were able to cash in millions of dollars worth of stock while it was near its peak. When the company then took out TV ads calling pilots greedy, many were outraged.

Northwest and its workers also failed to change how the company is run. Yes, three union representatives joined the board and the company asked them to stay on after the give-backs ended in 1996. But at the airport and in the sky, little changed. "We still have some of the employee committees," says pilot spokesman Paul Omodt, "but obviously they're not listening to us."

Compare that with UAL Corp.'s United Airlines Inc., whose employees bought 55% of the company in 1994. At United, the workers' share came in stock, and ticker-watching is now a daily ritual among employees. Moreover, the two sides set up procedures so that employees have a say

in running the place; workers vetoed a proposed merger with U.S. Airways in 1995. The two sides also use mediation more often to resolve such issues as retiree benefits. United pilots hope to reach a new contract before the current one expires in April of 2000—a rare feat in the industry.

Of course, United has its own labor troubles, but even those reflect

SMALL COMFORT

Northwest gave employees a financial stake—but no real place in its corporate decision-making process

the holes in its ESOP. Last spring, the airline and the International Association of Machinists & Aerospace Workers traded angry words when the IAM tried to sign up ticket agents. The union succeeded, largely because agents felt

excluded by the 1994 ESOP. Still, United's culture helped to prevent outright warfare. Says United CEO Gerald Greenwald: "To me, the test is whether we are able to talk our way through the tough issues."

That's a test Northwest and its unions have failed miserably. Pilots and executives are staring each other down while planes sit idle and other workers mull their own strikes. The question now is whether managers and employees can patch up their differences and get off the ground. If they wait too long, they risk a fate similar to that of Eastern Air Lines Inc. or Pan American Airways Inc.—carriers that set up ESOPs in the 1980s without really changing relations with employees. Just look in the corporate obituaries to see what happened to them.

Leonhardt covers aviation from Chicago.

GLOBAL INVEST



ASIA: NO SIGN OF THE BOTTOM

A year ago, it looked as if the worst of the crisis was over. But global investors are still running for the exits

ING

It took a while to happen, but what started with a financial collapse in Asia has become a global stock market implosion. High tech, banks, blue-chip manufacturers, and more are being swept away by a wave of pessimism. This year's Special Report on Global Investing offers some strategies to follow. Even if Asia doesn't recover soon (below), are there defensive stocks you should hang on to if you want to keep investing worldwide? Will the euro provide some support for Europe (page 70)? And will the bloodbath in Latin American stocks (page 72) choke off the region's recovery?

Fund managers winging in from New York or London to prowl Asia have known for months that the situation was bad. Ditto for global investors who have ripped open their Pacific Rim mutual-fund statements lately.

In the 18 months ended July 31, investors pulled about \$3 billion out of the 80 regional funds Morningstar Inc. tracks. It's easy to see why. Diversified Pacific funds tumbled at a 27% annual rate in the period. Those heavily weighted in markets outside Japan crashed 40%. Figures for August aren't in yet, but indications are the fund redemptions continued as markets plunged.

The general consensus among money man-

Special Report

agers a year ago was that the worst would be over by the end of 1998. Now, no one has any idea where the bottom may lie. Sure, managers say, there are extremely promising companies in Asia. And, yes, there are bargains among Japan's elite multinationals. But few are willing to back up those views with cash. "If you want to bottom-fish in the big blue chips, take your time—and prepare to take a three-year view," says David K. Thomas, co-manager of the \$430 million Putnam Asia Pacific Growth Fund, which is down 22% this year.

ONLY FOR THE BRAVE. Indeed, fund managers interviewed for BUSINESS WEEK's annual Global Investing Special Report are nearly unanimous: It's tough to argue in favor of buying anywhere in Asia until the ruckus calms down. If you are intrepid enough to plunge in to the gloom, you're best off sticking to companies with plenty of cash, clean balance sheets, and a unique technology edge or product.

But even such strong companies will suffer. And weakened companies in such smaller markets as Indonesia, Malaysia, and Thailand now seem to have little chance of making any come-

back soon. Malaysian Prime Minister Mahathir Mohamad's move on Sept. 1 to impose restrictions on foreigners converting ringgit into dollars or other currencies will only dampen investors' sentiments further—especially if other countries mimic the action. "We are very bearish on Southeast Asia," says Thomas, who started shunning such markets a year ago.

In the coming year, investing in Asia will be like playing three-dimensional chess. What started out as a regional ailment in Asia has metastasized into a broader emerging-mar-



First came denial. Then the gnawing realization that Asia's currency crisis last year was more than a passing squall. Now, Asia's mess is becoming an economic tragedy. South Korea, Indonesia, Thailand, and Malaysia are in free fall. In Hong Kong, monetary authorities have tried unsuccessfully to rig the stock market using as much as \$15 billion of taxpayers' money to ward off speculators. And Japan's political paralysis, crippled banks, stock market meltdown are the stuff of central banker attacks.

THE GLUM MOOD IN ASIA

JAPAN

Prime Minister Keizo Obuchi's ruling Liberal Democratic Party and opposition politicians are feuding over Obuchi's plan to address \$600 billion to \$1 trillion in bad bank loans. With the banking system paralyzed, the economy is slumping and stock prices have plunged close to a 12-year low.



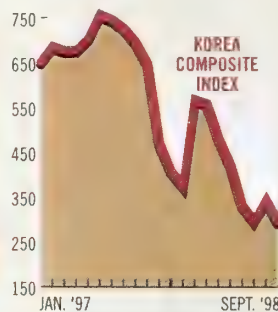
HONG KONG

After spending as much as \$15 billion to hold the stock market up, the government abruptly suspended its strategy and watched equities dive 7% Aug. 31. Some observers think the market is still overvalued by 20%, given a 50% bust in property prices and an economy likely to shrink in 1998.



SOUTH KOREA

Some 10% of the nation's listed companies have defaulted on debts this year, and no one knows who might be next. The weakened won is boosting some exporters' hopes, but the economy is shrinking, labor unions are successfully resisting big job cuts, and the *chaebol* are continuing to expand.



DATA: BLOOMBERG FINANCIAL MARKETS

ket cancer. Global investors are now so skittish that just about any bad news—whether a debt default in Russia or rumors of a Venezuelan devaluation—boomerangs back to Asia and deepens its crisis. The failure of traditional economic remedies promoted by the International Monetary Fund is a big drag, too. Hiking interest rates to defend currencies, wholesale corporate restructuring, more disclosure, and less

government meddling haven't done the trick. Most Asian countries are now in full crisis-management mode.

Special Report

GLOBAL INVESTING

And some of the emergency measures are anathema to the free-market purists often found running big mutual funds.

Valuing stocks is next to impossible as some markets begin to look like a rigged game. In Malaysia, where the economy contracted 6.8% in the second quarter, Mahathir is now spending public money to boost the stock market and cutting reserve requirements on debt-laden banks. If Japan's experience is any guide, the money will be wasted. Tokyo has spent billions in "price-keeping operations" to bolster stocks, but the Nikkei is now 65% below its 1989 peak.

SHOTGUN MERGERS. Huge salvage operations for the region's banks are also under way. Indonesia, South Korea, Thailand, and Japan are grappling with how to remove as much as \$1.4 trillion in dud loans from banks without detonating a financial panic. But the problem keeps eluding solution. In Seoul, the government has shut five banks but has also pushed others into shotgun mergers. That makes buying bank stocks a crapshoot. "You could be owning a strong bank today, and tomorrow the government will impose a weaker bank on you," says Stewart Kim, chief investment strategist at Pacific General Partners in Los Angeles.

Nowhere is the confusion more

debts, estimated at \$600 billion to \$1 trillion.

But even in its weakened state, Japan is still Asia's most powerful economy. So investors betting on an eventual recovery are probably best off sticking with a regional fund that has Japanese exposure. The \$33 million 59 Wall Street Pacific Basin Equity Fund focuses on multinationals that could benefit from a weaker yen, such as Nintendo, chipmaker Renesas, and Orix, Japan's largest equipment-leasing company. "I think the companies with the best earnings prospects are in Japan," figures manager Paul Fraker, whose fund is down only 1.4% for the year.

Other crisis plays involve companies with a near-monopoly in an industry segment or significant exposure to Europe where an economic expansion is still under way. Olympus Optical Co., up 60% in yen terms this year, boasts both. It has commanding 70% of the market for endoscopes, medical diagnostic equipment, and about one-quarter of its global sales come from Europe. Another favorite is Softbank Corp., a software distributor that owns the Ziff-Davis magazine publishing empire and the Comdex high-tech trade shows. The company has some \$4 billion in unrealized gains on its internet investments in the search engine Yahoo! Inc. and online trading company eManda Negi, an analyst with Merrill Lynch & Co. in Tokyo.

What to avoid? Just about every broker, bank, or heavily leveraged player in construction and real estate. Corporate bankruptcies are running at record levels and probably will accelerate as weaker banks continue to call in loans. What

palpable, nor the stakes higher than in Japan. Prime Minister Keizo Obuchi's ruling Liberal Democratic Party and the opposition parties led by Naoto Kan are locked in a game of brinkmanship over a bank bailout plan. Obuchi argues that any sudden failure of a money-center bank could spark a panic that would make the current turmoil seem minor. That's why he wants to pump up \$1 billion into the ailing Long-Term Credit Bank of Japan Ltd. to transfer most of its \$19.8 billion in bad loans to a workout vehicle before merging it with the Sumitomo Trust & Banking Co.

BLUE-CHIP BETS. Maybe saving LTCB, with \$190 billion in assets, makes sense as it has \$350 billion in derivative contracts with banks worldwide. But Tokyo is more away from dealing with the market. By Sept. 1, such uncertainty driven the Nikkei stock average down to 14,369, close to a 12-year low. That further weakened banks which include their vast shareholdings in their capital. No one has the confidence that the government knows the true scale of

What To Do

STICK to strong companies with cash and unique technologies. But take the long view. Recovery may be three years away.

HUNT for bargains in Japan, if you're brave. Olympus Optical and Softbank, the publisher and software giant, are two favorites.

BYPASS Southeast Asia. But the cheaper won is giving exports from South Korea's Pohang Iron & Steel a healthy boost.

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THE WAR IN KOREA

An auto worker who jacket says "Save job security!" scuffles with a nonunion employee. The nation's transition is sure to be painful.

hang Iron & Steel Co., world's lowest-cost producer, is on most buy as cheap exports rise.

Yet few count on South Korea to make an easy transition to a more market-driven economy. It shrank 6.6% in the second quarter, and with unemployment running at a record 7.6%, President Kim Jong is under big pressure to back down from the radical corporate restructuring and industrial downsizing the economy desperately needs.

more, investors have few means to distinguish winners from losers. Obuchi won't release new government audits of Japan's 19 major commercial banks. "We're dancing at the edge of a cliff," says ING Barings analyst James Fiorillo.

The same can be said about Hong Kong, the region's second-biggest stock market. The market's reputation has been damaged by all the official efforts to prop it up.

When the Hong Kong Monetary Authority first intervened on Aug. 14, it pushed up the Hang Seng index from its five-year low. But once the news of turmoil in Russia surfaced, Hong Kong was caught in the undertow and abandoned intervention. On Sept. 1, Standard & Poor's Corp. (like *BUSINESS WEEK*, a unit of The McGraw-Hill Companies) downgraded Hong Kong's foreign-currency debt a notch, to A. Now, analysts think that

Labor unions seem willing to risk confronting riot police to avoid deep job cuts, as they successfully did with Hyundai Motor Corp. in early August during a standoff at the company's auto complex in Ulsan. And instead of shutting or turning off unprofitable units, the big *chaebol* industrial combines continue to expand. Despite an auto capacity glut, Hyundai, Samsung, and Daewoo have recently raised a total of \$4.5 billion through bond issues so they could bid in the international auction for Kia and truckmaker Asia Motors.

Any way you cut it, the crisis carries a harsh lesson: Asia's work ethic and vast savings couldn't compensate for the region's sloppy lending, government meddling, and corruption once the boom went bust. Global investors bolted—and it will be a long time before they come knocking again.

By Brian Bremner in Tokyo, with Mark Clifford in Hong Kong, Moon Ilwahn in Seoul, and Lawrence Straus in New York

Special Report

GLOBAL INVESTING

Aug. 14, it pushed up the Hang Seng index from its five-year low. But once the news of turmoil in Russia surfaced, Hong Kong was caught in the undertow and abandoned intervention. On Sept. 1, Standard & Poor's Corp. (like *BUSINESS WEEK*, a unit of The McGraw-Hill Companies) downgraded Hong Kong's foreign-currency debt a notch, to A. Now, analysts think that even at 7,800, the Hang Seng Index is probably overvalued by about 20%, given the 50% bust in property prices since last year. Sooner or later, analysts expect, the market will fall close to 6,000.

SEOUL'S SURVIVORS. The news from South Korea is even grimmer. One in 10 listed companies has defaulted this year. Even the savviest financial hand has trouble figuring out who might be next, thanks to opaque accounting practices. Worse yet, the government canceled its auction of bankrupt Kia Motors Corp. Sept. 1, with Ford Motor Co. and Korean bidders pressing Seoul and Kia's banks to take a huge hit on the carmaker's \$7.4 billion in bad debts. Another auction is set for October. In the meantime, Pacific General's Kim thinks he has found some survivors. One is Dae Duck Industrial Co., a maker of circuit boards with supply contracts with Toshiba Corp. and Siemens. Its stock is up 7.8% this year. It has few debts and about \$36 million in cash. Po-

A FAULTY CRYSTAL BALL

This has been a cruel year for Asian stock markets." That's what *BUSINESS WEEK* observed 12 months ago in our annual Special Report on global investing. But 1998 has been even crueler, making mincemeat of our advice to start bottom-fishing in Asia.

Along with many Wall Street pros, we underestimated Southeast Asia's woes, the inability of Japanese politicians to address deepening economic problems, and how turmoil in other emerging markets would affect the Pacific Rim. And while for the most part, we stuck to recommending the best and brightest companies, they

were swept away with the dross. Toyota Motor Corp.'s American depositary receipts have sagged 25%, even as Camrys and Lexuses keep rolling out of U.S. showrooms. And Tokyo Electron Ltd. has plunged 60% in dollars, despite its edge in making gear to manufacture semiconductors. We figured the collapsing Indonesian rupiah would help Asia Pulp & Paper Co.'s exports. Maybe will someday, but its ADRs are still down 50%. The lesson? When a global economic earthquake hits, it may be safest to wait for the aftershock to end before venturing forth.

By William Glasgall in New York



EUROPE: SUDDEN CHILL OR DEEP FREEZE?

Strong fundamentals may help its stocks recover from Russia's hit

Until early August, Continental European markets looked like the hottest prospect outside the U.S. With a strong economic recovery under way and a significant boost expected from the launch of the euro on Jan. 1, they even seemed poised to take over equity-market leadership from Wall Street's tiring bulls. But suddenly, fallout from the world's economic crisis zones is dimming Europe's bright aura.

Special Report

GLOBAL INVESTING

knocked 15% off European equities since their July peak (charts). The worries are well founded. German and other European banks have lent heavily to Russia, which has declared a debt moratorium. Besides, about 40% of Europe's exports go to emerging markets. As a result, European banks and companies could face a profit shock later this year. In a

Anxiety about Russia's financial collapse and Asia's scary economic landscape has

worst-case scenario, the euro could have a baptism of global turmoil is still rampant when it debuts. A deep crisis could cost Europe 0.5% to 1% of its expected growth in 1999.

Europe faces a rough ride for some time. Analysts say. Richard Davidson, an equities strategist at Morgan Stanley Dean Witter in London, figure that Continental market contract as much as 10% more through October. But deal is cut to help Russia, earnings remain stronger merger boom starts, the uptrend could resume.

Inflation and interest rates are low. Past corporate structuring efforts are poised to pay off. And a new generation of managers who believe in shareholder value is moving onto the scene. Also, moves to permit share buybacks, with the emergence of bustling over-the-counter market high-tech stocks, are improving Europe's financial landscape.

Such trends convince many market strategists that European equities could outperform U.S. equities over the

three years. For one thing, corporate earnings are still expected to rise 15%, vs. low single digits in the U.S. European stocks "are at the most attractive levels early 1995," says Otto Wasser, head of investment research at Bank Julius Baer in Zurich. François Lengladeyen, global equity chief at Credit Suisse First Boston, says Europe will shrug off the jitters and rebound by 15% by yearend, setting the stage for a rise of as much as 30% by the end of 1999.

Until now, Europe has been caught in a web of more than 15 currencies and regulatory regimes. But the advent of a single monetary union and the euro could create a seamless market. "EMU is a catalyst for the single market," says Michael A. Levy, a managing director at BT Funds Management. "It is reinvigorating manufacturing industry." Four of BT's \$2.1 billion international portfolio is now invested in Europe.

Clearly, Europe has lots of work to catch up with the U.S. Industrial companies lag a bit behind American rivals in restructuring. So returns on capital employed in Europe average a bit lower, at 8%, vs. 15% in Britain and 12% in the U.S. Optimistic strategists say Europe Inc.'s return on capital could rise to 10% or 12% over the next two years. "That's quite an improvement and will have a significant impact on market return," says Peter Oppenheimer of London's HSBC Securities.

BUYBACK WAVE? Returns to shareholders could be helped in other ways. Share buybacks still face hurdles in some countries. But many have authorized them this year, while France, Italy, Sweden and the Netherlands have legislation pending. A buyback wave is the result. Just \$6 billion was spent on Continental buybacks in 1997, but that could double, to \$13 billion, this year. Among candidates, says Credit Suisse First Boston, are BASF, SGL Carbon, Total, Danone Group, and Volvo. Europe's boosters figure that investment flows to Europe will surge as its equity culture broadens. Morgan Stanley predicts that inflows into European equity markets will total \$13 billion from now to 2010, roughly doubling Europe's market capitalization as a percentage of its gross domestic product, from just 45% in Germany vs. 140% in the U.S. Low interest rates may spur a shift from bonds to equities, as will a move from pay-as-you-go state pension systems to American-style private plans based on mutual funds.

Even many analysts' steadfastly bullish outlook for Europe's long-term future, the sharp correction may be an opportunity to snap up beaten-down tech companies. With its American Depositary Receipts at \$49.25, for instance, German giant SAP is off 20% from its July 31 peak. World-

beating mobile-phone maker Nokia Corp., whose ADRs are 19% off their summer high of \$92, is another favorite.

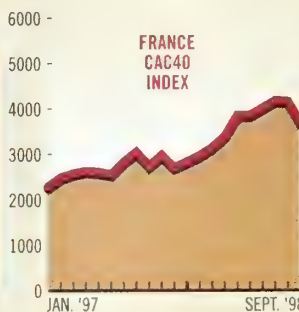
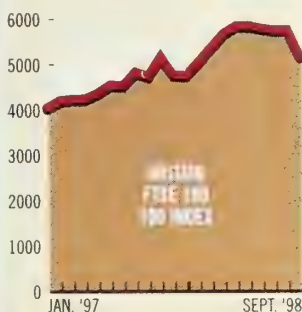
Companies poised to benefit most from balance-sheet restructuring are in overcapitalized, mature industries. They include utilities moving into telecommunications, such as France's Vivendi and Suez Lyonnaise des Eaux. Old-line German manufacturing conglomerate Preussag is moving into travel services. Of course, managements still have to make their new strategies pay off.

Although banks have taken a drubbing because of their Russian lending, not all are equally exposed. London-based Salomon Smith Barney banking analyst Matthew Czepiewicz recommends two Dutch banks, ABN Amro and ING Groep, precisely because of their limited Russian exposure. Insurers such as France's Axa-UAP and Holland's Aegon could benefit

CROSSCURRENTS BUFFETING INVESTORS IN EUROPE

BAD NEWS ABROAD

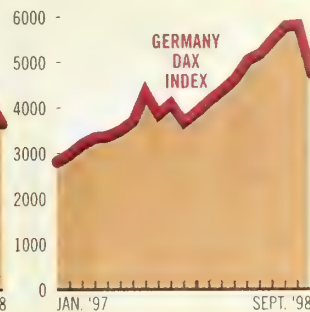
Continental Europe's strong economy has seemed immune to Asia's financial collapse. But Russia's political and economic implosion has finally made investors realize that the emerging-market recession is spreading quickly. That's bad news for profits, since emerging markets now account for 40% of European exports.



DATA: BLOOMBERG FINANCIAL MARKETS

BETTER NEWS AT HOME

Interest rates and inflation are low. And Europe's plan to launch the euro on Jan. 1 will put pressure on companies to restructure. Some analysts expect corporations' return on capital to increase by as much 50% over the next two years as a new breed of investor-friendly managers cut costs and go ahead with share buybacks.



from the euro. And telecommunications companies are favorite defensive plays, thanks to a boost from deregulation, even if growth slows. Foodmakers such as France's Danone tend to survive downswings well, too. New Chairman Franck Riboud could raise another \$5 billion by sales of underperforming assets.

Many analysts also see promise in a select group of mid-cap stocks, despite their underperformance in the U.S. "The key is finding world-class companies that do what they do better than anyone else," says Michael Kraland, president of Trinity Capital Partners in Paris. Among analysts' favorites: French auto supplier Valeo, Holland's Airspray, and Benckiser, a German-Dutch maker of dishwasher detergent that went public last fall.

Europe could now have more medium-term potential than the U.S. But companies may find it difficult to translate restructuring and the euro into shareholder returns in the near term. Yet intrepid investors still view Europe as a haven from the global crisis. They are betting this late-summer market correction will be just that—disturbing, perhaps, but not enough to knock Europe off its feet.

By Gail Edmondson in Paris, with Karen Lowry Miller in Frankfurt and bureau reports

What
To
Do

BUYBACKS will support equities. Companies expected to repurchase stock include BASF, Schering, Total, Danone, and Volvo.

HIGH-TECH stocks still show promise. Two favorites include software maker SAP and mobile-phone manufacturer Nokia.

BANKS aren't all facing big trouble in Russia. Two that are not are Holland's ABN Amro and ING Groep.

LATIN AMERICA: MORE WHERE THAT CAME FROM

The region faces further pain, but intrepid investors can find defensive play

How low can they go? That's the guessing game investors in Latin America are playing right now.

Turbulence in Asia and Russia has knocked major Latin stock markets down by as much as 72% in dollar terms this year, with much of the collapse coming after the Russian ruble devaluation on Aug. 17. Brazil, under pressure as the government struggles to prevent a devaluation of the real, lost 40% in August. Mexico and Argentina are down by half since Jan. 1, and Chile, long the region's economic model, is at its lowest level since 1993. Amid the dizzying flight from emerging markets, shares of well-managed companies with solid balance sheets are plunging along with weaker ones burdened with debt. "Rational analysis of stocks has been abandoned," says Susan Gilbertson, head of Latin American equity sales for Banque

further punish the region's markets. "If you're looking ahead a year or 18 months, prices will be significantly higher," predicts Jorge Mariscal, Latin America equity strategist at Goldman, Sachs & Co. in New York. "But there could be more downside movement first."

Even Latin America's safe havens offer little sanctuary. Government debt, for instance, had been steadier than equities. But that changed with Russia's devaluation. With investors running scared, Mexico had to cancel its weekly



Special Report

GLOBAL INVESTING

Paribas in New York. "Everyone is afraid of their shadow."

Most analysts recommend sitting on the sidelines until Russia and Asia show signs of stabilizing, however tempting Latin stock prices may look. In Brazil, "investors are valuing stocks as if a [currency] devaluation had already taken place," says Walter Stoeppelwerth, director of Latin American research at Robert Fleming Securities in São

ON THE FLOOR IN SAO PAULO

"Investors are valuing stocks as if a [currency] devaluation had already taken place," says one Latin America analyst

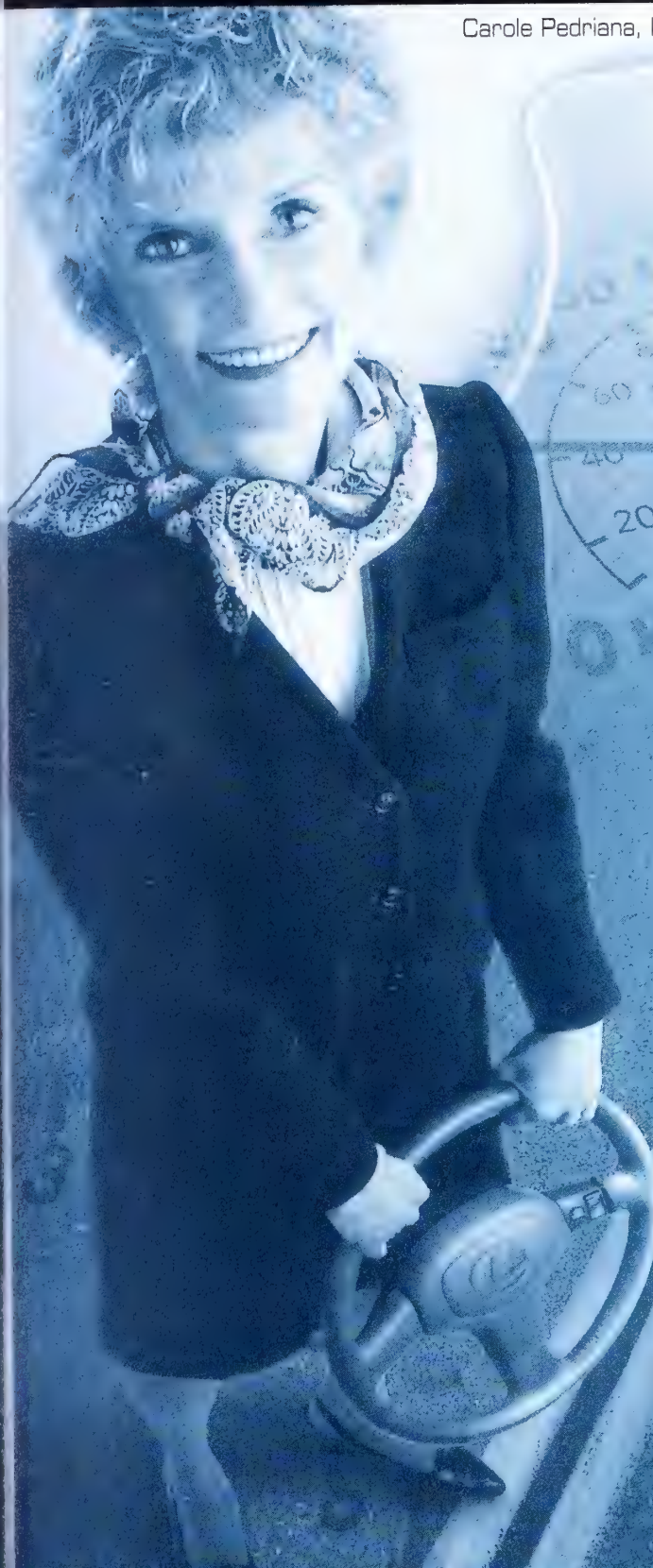
Paulo. Take one of Brazil's largest banks, Banespa, which is controlled by the state government but scheduled for privatization next year. It sells at a meager 3.5 times estimated 1998 earnings. But investors in Brazil and the rest of Latin America have to accept that events half a world away could

survive devaluation, rising inflation, and a weaker global economy. Companies with little debt or dependence on ex-

surry-bill auction on Aug. 31. And widely traded Brady bonds lost about 30% of their face value in August, cutting investors' appetite for the region's long-term debt. Yields are at their highest since Mexico's 1994 devaluation. Governments will have to pay more to finance deficits, and companies will find it hard to raise cash by selling bonds. A spike in bond prices may be needed before stock markets can recover. So investors need a defensive strategy, analysts say. "It's crucial to stick to good names," says Dan Fraser, head of Mexico research at Warburg Dillon Read in Mexico City. That means hunting down companies that can survive devaluation, rising inflation, and a weaker global economy. Companies with little debt or dependence on ex-

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to rev up sales.

Carole Pedriana, National Manager, New Era Business Project



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should head the list, analysts say, while those linked to commodity exports—such as copper mines in Chile and grain exporters in Argentina—should be avoided.

If there are any defensive plays left at all, they're telecom companies, such as Teléfonos de Mexico or Telebrás in Brazil. They have been badly beaten down, to be sure. But for investors determined to maintain a stake in the region, they may offer some protection against even steeper market declines. For one thing, telecom stocks are widely held, so they can be dumped quickly if necessary. And they are less affected than most companies by economic swings or the threat of devaluation because they supply essential services, mostly to domestic buyers. Telmex now trades at about nine times estimated 1998 earnings, generates plenty of cash, and has weathered the opening of Mexico's long-distance market. American depositary receipts of Telebrás, privatized in July, are down 52% from their 52-week high, at \$71 a share.

But the profits expected to be garnered someday from pent-up phone demand can't protect Brazil right now. One big reason: Global investors remain troubled by Brazil's budget deficit of 7% of gross domestic product, \$260 billion in government domestic debt, and an overvalued currency. A gargantuan \$11 billion fled Brazil in August, cutting the central bank's hard-currency reserves to \$64 billion as it struggled to defend the real. In response to the currency pressure, the government has made it easier for foreigners to invest in Brazil. But few are taking the bait. Economists figure that if currency reserves drop below \$50 billion, the government will be forced to adopt austerity measures, including

raising interest rates sharply. Last October, it fended off speculators by doubling rates, to 43%, but the economy came to a halt and GDP is expected to grow barely 1% this year as it is. President Fernando Henrique Cardoso, favored to win reelection on Oct. 4, will likely try to avoid moves that might alienate voters until after the election. But if global market conditions worsen, he may have no choice.

Even if Brazil makes the right moves to please global investors, the reward may be a long time coming. That has been Mexico's recent experience. Its government still is in the throes of sorting out a banking crisis that will cost taxpayers \$60 billion. But otherwise, it has shown admirable fiscal discipline, cutting the budget three times to make up for declining oil revenues, while GDP is expected to grow 4.5% this year. "Mexico has done everything to ensure a stable cur-

FIRST ASIA, THEN RUSSIA, NOW LATIN AMERICA

MEXICO

Stocks are down by half, in dollars, since Dec. 31, even though the economy is expected to grow 4.5% this year and the government has slashed spending and inflation. But investors still view Mexico as an emerging market.



ARGENTINA

Argentina has one of Latin America's soundest economies, but it is being punished for its close trade ties with Brazil. Stocks are down to their lowest level since 1995, and the peso's 1-to-1 peg to the dollar is hurting exporters.



BRAZIL

A deficit of 7% of GDP and an overvalued real make Brazil an easy sell for the gun-shy. The Central Bank has \$64 billion in reserves. If they fall below \$50 billion, President Cardoso may hike interest rates—after the Oct. 4 presidential vote.



DATA: BLOOMBERG FINANCIAL MARKETS

rency, reasonable growth, and lower inflation, and it's getting whacked just the same," says Paribas' Gilbertson.

The same goes for Argentina. Its economy is among the soundest in Latin America, with 4.5% growth expected this year. But its close trade partnership with Brazil is a major drag when the going there gets tough. Besides, Argentina's peso is managed by a currency board that has pegged it 1-1 to the U.S. dollar. Although most observers expect the peso to hold, a rise in the greenback crimps exports. Investors worry, too, about the impact of lower commodity prices on company YPF and food producers such as Molinos Rio de la Plata. As a result, the Buenos Aires stock market index is at its lowest level since April, 1995, when the country was in the midst of a deep recession.

HAZE-COLORED GLASSES? Latin America's weakest link is Venezuela, where stocks are down 72% in dollar terms this year. Low oil prices have reduced government revenue, sending short-term interest rates above 100%. Now, the weakening bolivar is a candidate for devaluation before year's end, says Goldman's Mariscal. Although Venezuela's economy is only the fifth-largest in the region, a currency crisis could weaken investor confidence in neighboring Brazil and push Latin markets even lower.

The worst may not yet be over. The region could be in more pain, particularly if commodity prices continue to slip. Some analysts argue that investors exaggerate the importance of commodities to the region, except in Venezuela and Chile, which remain dependent on oil and copper. "Oil is important to Mexico, but the Mexican economy has become much more diversified in recent years," says Gilbertson. "Market perceptions are clouding reality." But the haze isn't going

to lift as long as global markets near the frontiers of panic. To invest in Latin America, says Alberto Verme, managing director for Latin America at Salomon Smith Barney in New York, "you need patience." And a high tolerance for risk.

By Ian Katz in São Paulo, and Elisabeth Malkin in Mexico City

Special Report

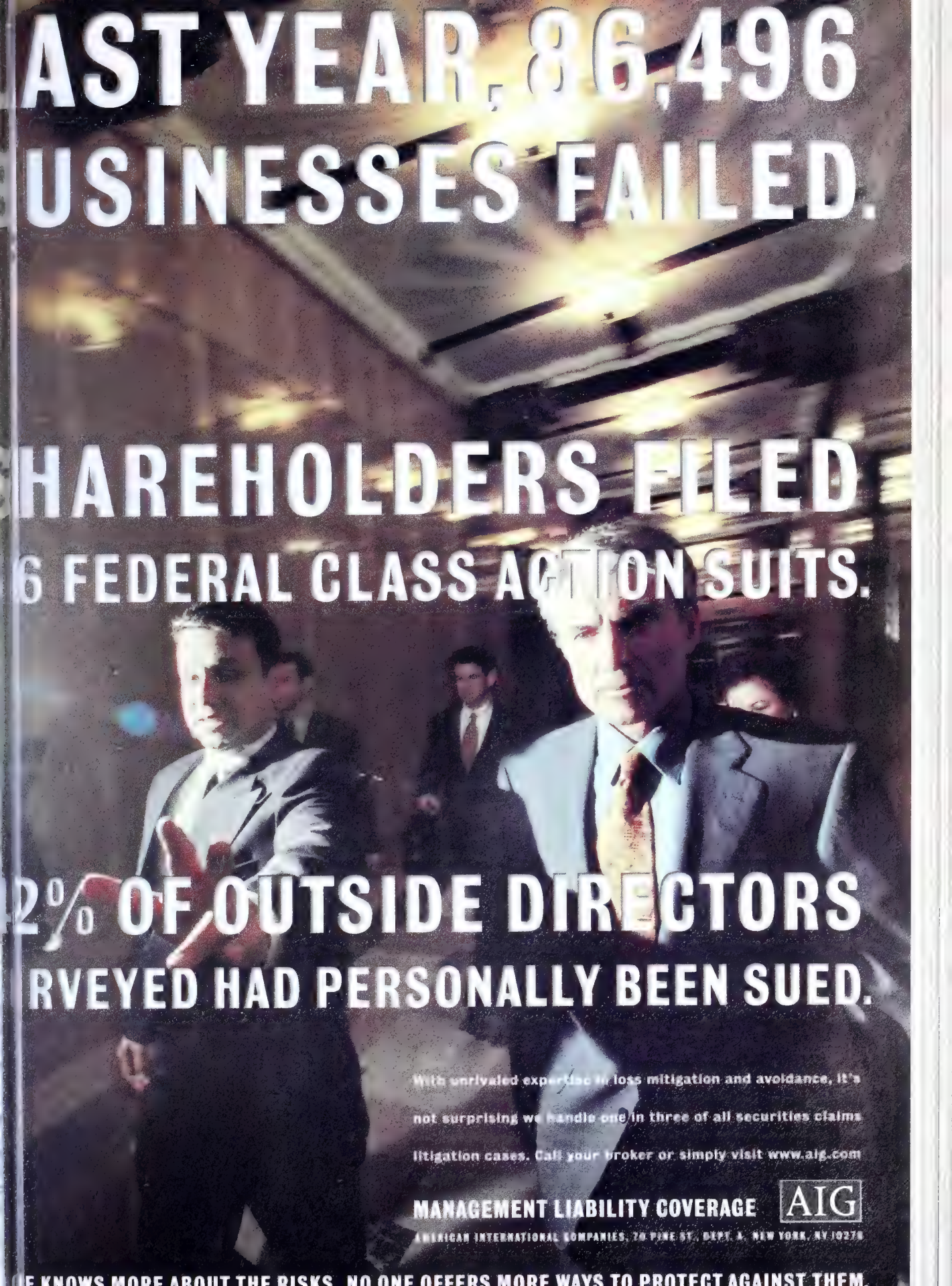
GLOBAL INVESTING

What To Do

FAVOR defensive stocks. Teléfonos de Mexico now sells at only nine times earnings. Chilean phone company CTC is also worth a look.

LOOK for bond bargains. Some U.S. fixed-income mutual funds are snapping up Latin debt at their lowest prices since 1994.

BEWARE new trouble in Brazil. The real is under pressure, and the government may have to hike interest rates.



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BILL'S CO-PILOT

After 18 years at Microsoft, is Steve Ballmer ready to be president?

It was vintage Steve Ballmer. Microsoft Corp.'s self-appointed cheerleader bounded onstage at the company's annual sales meeting in New Orleans on July 27 and shouted at the top of his lungs: "I love this company! I love this company! I love this company!" The 6,000-person sales team responded with a five-minute standing ovation. Then Ballmer whizzed through a 90-minute pep talk on the virtues of customer obsession, bringing the audience to its feet once more when he finished by playing a recording he listens to before every major milestone in his life: Dionne Warwick's *I Say a Little Prayer*.

Ballmer might need their prayers. After six years of running sales and support for the software giant, he has been elevated by CEO William H. Gates III to the position of president—in charge of both sales and product development—allowing Gates to focus more on technology and mapping out the company's future.

With this move, Steven A. Ballmer finally gets public recognition for the role he has long played at Microsoft: Bill Gates's co-pilot. Together, the two college chums have spent 18 years forging a fiercely competitive company unmatched in computerdom. Gates has been the company's big brain and Ballmer its wildly thumping heart, inspiring the troops as no one else can. Now, while Gates remains CEO and point man in the company's antitrust battle

with the Justice Dept., it's up to Ballmer to run day-to-day operations at a juncture that's as crucial as any in the company's history.

Microsoft is under fire from all sides—not just from Justice but from tough competitors such as IBM and Sun Microsystems Inc. To sustain a blistering 28% yearly growth rate, Microsoft must succeed in markets far afield from its dominance in desktop computing. That means persuading corporate customers that Microsoft's software can be trusted to run their most vital operations. At the same time, Microsoft is pushing its Windows software into everything from cars to building alarms to telephones. And the company must transform its Web sites, which lost \$300 million last year, into moneymakers.

GIMLET-EYED. In many ways, the 42-year-old Detroit native is tailor-made for the job. While Gates is the company's technology visionary, Ballmer is its top business strategist. He earned his stripes by building Microsoft's sales operation into a major-league force in corporate computing. He has had every major management job at Microsoft, and he has the kind of gimlet-eyed financial discipline necessary to pick apart the flaws in any ailing business plan.

Already, Ballmer is sending hundreds of product engineers out to learn from corporate customers what Microsoft needs to do to help solve their computing problems. He is doing sit-downs with some 100 employees to ferret out what's happening with product development. And he is boning up on what makes a Web site a hit. Look for him to whip into shape the company's E-commerce operations by boosting revenues and pruning unnecessary costs.

Ballmer's omnipresent intensity should help. He's larger and louder than life—6



feet tall, built like a linebacker, with a huge, balding head and a booming voice. Despite his stock options worth some \$6 billion, he's not easing off one bit and responds with bug-eyed indignation to rumors he was considering retirement before getting his promotion. "That's just not true," he says. He's the kind of guy who, while jogging, charges up hills—gutting out the pain.

At home, too, Ballmer's devotion is boundless. He tries to be there to pick up his two young sons to bed every night. And when his parents became ill with cancer last summer, he moved them to Seattle and took 12 weeks off from work to care for them. "Not too many senior executives will just drop out of

"Our friendship has grown much stronger as a result of work"



STEVE BALLMER

AGE 42

CHILDHOOD Grew up in Farmington Hills, Detroit. Father worked as an accountant for Ford.

EDUCATION BS in math in 1977 from Harvard University. Spent one year at Stanford University business school before Microsoft CEO Bill Gates, a Harvard pal, lured him away with the promise of a 7% stake in the company.

CAREER Began in 1977 as an assistant product manager at Procter & Gamble, marketing cake mixes. Then 18 years at Microsoft running administration, marketing, products, and sales and support.

FAMILY Wife, Connie, is a former Microsoft public-relations person. Two sons. They live in a colonial house near Microsoft's Redmond, Wash., campus.

CAR True to his Detroit roots, drives a red Lincoln Continental.

HOBBIES Passionate about sports. A Detroit Pistons fan and a regular at Seattle SuperSonics games.

PERSON HE ADMIRE MOST His parents, "for their balance of patience and acceptance with motivation and agitation."

WHAT KEEPS HIM UP AT NIGHT Nothing, unless he's hurt his back playing basketball.

for their family," says Mike Maples, former Microsoft executive vice-president who is now retired. Ballmer's intensity has a dark side. He can sometimes be a hothead and his emotions get the better of him. He can be rough on people who work for him, bawling them out so violently that his voice can be heard through the windows at Microsoft's Redmond (Wash.) headquarters. And sometimes, Ballmer lets out public comments that simply don't become a company president. Maples—no diplomat himself—doesn't mince words about Ballmer's shortcomings against him. The two have been close friends since they met as undergraduates at Harvard University. Later, in 1980, Gates per-

suaded Ballmer to drop out of Stanford University's business school to help run a fledgling Microsoft that was growing so fast it was nearly out of control. Ballmer was the company's first nonengineer, and Gates valued his management experience at Procter & Gamble Co., where he helped market cake mixes.

Even today, they spend hours together talking over their frustrations and dreams. "He's my best friend," says Gates. "We love working together on very hard problems. We trust each other and understand how the other one thinks." Ballmer's affection for Gates runs just as deep. "Our friendship has grown much stronger as a result of working together. It's like a marriage,"

says Ballmer. In an interview last fall he said Microsoft's vaunted long-term approach to business emerged partly because he and Gates "wanted to prove our commitment to one another."

But where Gates calculates his moves, Ballmer simply makes them. "Steve's invention is: Don't have an elegant plan. Do the smart, obvious thing. Then fix it as you go," says Peter Neupert, a former Microsoft executive who is now CEO of Drugstore.com.

As president, Ballmer will have to be more judicious—and diplomatic. "He's proven he can be General Patton," says Paul A. Maritz, Microsoft's group vice-president for products. "Now, he has to be more like Eisenhower." Ballmer is

her," Ballmer says of Gates. "It's like a marriage"



PRESIDENTIAL PRIORITIES

In his new role, Ballmer will focus on:

CUSTOMER SATISFACTION Ballmer plans to spend \$250 million this year to boost customer support and consulting staff by 25% each. Next month, he will send hundreds of engineers into the field to meet with corporate customers so they can better understand their problems.

CORPORATE SOFTWARE SALES Microsoft's Windows operating system and desktop productivity suite account for the bulk of revenues. Ballmer will focus on increasing market share in the corporate database and E-commerce businesses—without pricing so low that profits suffer.

THE WEB BUSINESS Microsoft has invested more than \$1 billion in online ventures, but it's still losing hundreds of millions a year. Ballmer wants revenues to grow much faster, so expect him to subject the Web business to the same kind of stringent performance requirements he applied to the sales organization.

SMALL IS SMART With 27,200 employees, Microsoft is in danger of catching a bad case of big-company-itis. Ballmer will look for ways to move key employees around internally so they face new challenges and stay energized.

working on that. On Aug. 6, he ventured into hostile territory to meet with the CEOs of 10 Silicon Valley startups intent on persuading them to see Microsoft as an ally. "I was impressed," says Naveen Bisht, CEO of Ukiah Software Inc. in Campbell, Calif. Ballmer even promised to call venture capitalists on their behalf.

TO THE RESCUE. Mostly, though, Ballmer's new job keeps him close to home and focusing on his two new priorities: making sure all the company's businesses are operating at peak performance and notching up Microsoft's dedication to customer satisfaction. "I'm going to dial up my focus on delighting customers," he says.

That may sound like so much marketing hokey, but Ballmer is in earnest. Some customers say they rarely meet a software executive so attuned to their needs. Richard Schell, vice-president of

information systems at ABC in New York, says Ballmer came to the rescue when he ran into technical problems after switching to Microsoft's Windows software three years ago. And two years ago, after Schell suggested a change in Microsoft's basic licensing agreement during a Microsoft-sponsored gathering of corporate customers, Ballmer convened a meeting on the spot and solved the issue by the next morning. "I find it very comforting that within a huge domain of Microsoft they have a senior person who is so sensitive to customer needs," says Schell.

Obviously, it's not altruism that drives Ballmer. He understands that for Microsoft to keep up its sizzling growth, it has to make customers out of millions of people who don't use PCs now, plus find compelling reasons for corporations to buy upgrades. Part of it is getting products out the door faster—like the ta-



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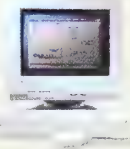
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le of Windows NT. But most cru-
Microsoft's products need to get
easier to use and manage.
help achieve that goal, Ballmer
dgeted an extra \$250 million this
o increase the company's consult-
d support staffs by 25% each and
technical seminars for 2.3 million
consultants and software devel-
Also, Ballmer plans to send en-
s out to learn from customers.
just about figuring out the latest
e to put into Windows NT, the
k operating system that's the ba-
Microsoft's corporate-computing
gy. Ballmer wants to understand

The board—worried
by Ballmer's fiery
nature—took months
to O.K. his promotion

the gaps are in the entire prod-
e. "It's a blitz session to dig in
ar what's out there," he says.
boosting traditional software
won't be enough to keep Mi-
s revenues soaring. Ballmer is
g hard at the company's Interac-
edia Group (IMG), which has had
uits, such as its Expedia travel
ut has failed to make the Mi-
Network online service a major
n cyberspace. Now it's trying to
e Yahoo! by transforming MSN
o-called portal site that serves as
way to the Web and routes cus-
to Microsoft's own travel, in-
st, and shopping sites.

HEMORRHAGE. To get himself up
d on the portal business, Ballmer
hat he calls a "crash course" dur-
ree days of talks in June with ad-
rs and ad agencies in Chicago and
ork. While he thinks revenues
be growing faster, he supports
npany's high level of investment
o sites. "The quibbles are about
the appropriate target for payoff,"
s. Financial analysts, though, are
patience with the profitless Web
es. "Red West should be called
k," scoffs David Readerman of
sBanc Montgomery Securities
referring to the satellite office
those businesses are located in
nd, Wash.

Higgins, head of the IMG group, is
ecting conflicts with his new boss.
hard on budgets, but so am I,"
s says. Ballmer says his new job

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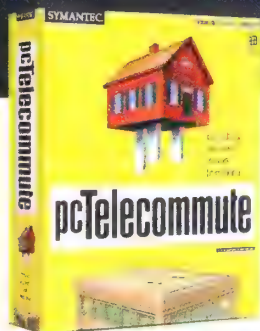
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T MAN

ner is always up for company jinks. In November, 1988, he n across a chilly Microsoft , on a dare

o much to root out problems as to em in the bud. "Nothing's wrong," ys. "But many things could go if we don't prepare today."

just that kind of edginess that d Gates on the path to appointing er president. In a memo to the of directors and top execs last nber, Gates revealed his frustra- Less than half of his time was thinking about technology. And as concerned that Microsoft was ing too bureaucratic. Then there he Justice investigation—which rel in a May lawsuit charging Mi- ft with anticompetitive business ces. "He was feeling a bit over- ned and not having as much fun as e past," says board member Jon irley, who was Microsoft's presi- for much of the 1980s.

l, it took more than six months for oard to settle on making Ballmer lent. One hangup was his fiery per- ty. "Steve's greatest strength can e seen as a weakness," says board er and Ballmer friend David Mar- t. Ballmer shouts when he gets ex- or angry—his voice rising so sud- that it's like an electric shock. could be intimidating to people

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...didn't have a lot of self-esteem,"
 Scott McGregor, a Windows devel-
 opment manager in the mid-1980s who is
 now a top executive at Philips Semicon-
 ductors. By the early 1990s, Ballmer had
 undergone throat surgery to fix problems
 caused by shouting.

FACTOR. Then there was the
 Reno incident. Last fall, in front
 of reporters, he made the colossal blun-
 der of sneering "To heck with Janet
 Reno" after the Justice Dept. sued Mi-
 crosoft. That comment made headlines
 and hurt Microsoft's already battered
 image. Ballmer says he deeply regrets
 the comment. "That's the way I am,"

**Nothing's wrong. But
 many things could go
 wrong if we don't
 prepare today"**

...rs. "I have to work on being a
 better version of myself."
 According to Shirley, Gates cleared
 the way for Ballmer's promotion by
 making sure each of the executives who
 report to him was satisfied with
/>
 arrangement and by convincing the
 that he could modify his behavior.
 Ballmer may be sorely tested in coming
 when Justice Dept. attorneys grill
 him in a deposition. So far, though,
 one of the few top Microsoft exec-
 utives who has not been portrayed as a
 liability in government filings.

Ballmer's friends forgive his excesses,
 even some Microsoft critics are will-
 ing to cut him slack. "I find him re-
 freshing. There's a joy and love of life
 about him," says Ken Wasch, director of
 the Software Publishers Assn. Ballmer
 is the most of the time. He cracks
 jokes and laughs and says things such
 as "la la!" People warm up to him
 because he has an incredible knack for
 remembering their names—and even
 their kids' ages.

At all, Ballmer is an all-around
 sportsman—always up for company
 stunts and publicity stunts. He
 drove across a chilly Microsoft campus
 in November, 1988, on a dare. And
 later, he and Gates portrayed a cou-
 ple of buddies out for a drive in a video
 of a Volkswagen ad that was
 shown at public-relations events. They
 drove up a Sun Microsystems comput-
 er on the side of the road—then un-
 der it after they noticed a stench.
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As a child, Ballmer was keen on having a mother he adored and a demanding Russian immigrant father. His father, who worked in accounting at the Motor Co., didn't go to college. Ballmer can remember being told in uncertain terms when he was eight that he would attend Harvard. His dad had a relentless work ethic and urged Steve and his kid sister to buck down. "He'd always say 'If you're going to do a job, do the job,'" Ballmer says. And he remembers that his grandfather, a veteran of the czarist army who sold used auto parts, gave him a \$6-per-month allowance, but insisted that he turn it over to his mother—perhaps the genesis of Ballmer's notorious tightfistedness at Microsoft.

WHIZ. Ballmer wasn't always so shy. He was shy as a child—so much so he remembers, that he hyperventilated before heading off to Hebrew school. He only became confident once he got used to new people and situations. As a scholarship student at Deerpark Country Day School, he was a spirited—if mediocre—defensive tackle on the Yellow Jackets football team. Childhood friend Steve Pollack, the team's quarterback, bested him every time during scrimmages. "But Steve would never give up. He'd keep coming and going," says Pollack.

Ballmer turned out to be a math whiz—ranking in the top 10 among 1,000 high schoolers on a statewide math test—helping him achieve his father's dream, a Harvard education. There, he

Then he sneered "To heck with Janet Reno!" last fall, it cost the company dearly

His start as a leader—as manager of the football team, the *Harvard Crimson* student newspaper, and the literary magazine. But it was his hookup with classmate Bill Gates that sealed his fate as a future captain of industry. They lived at opposite ends of a dormitory floor—but their shared passions for math and science brought them together. They teamed up to study and competed fiercely at trivia games and academics. Ballmer still rues the day he was outscored by Gates with a final test score of 99 to Ballmer's 97 in a macroeconomics course for which neither of them attended a single class. The com-

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petitive jousting continues to this day. Gates and Ballmer recently brought a staff meeting to a temporary halt while they tussled over exactly how much bigger BellSouth is than US West.

These days, Ballmer's commitment to Microsoft matches that of Gates. Sometimes, he'll handle overseas business reviews from 7 a.m. one morning to 2 a.m. the next. And no marketing stunt is too wacky. Take the time he dressed in a baseball outfit for the launch of Office 97 at Club El Nogal, a nightclub in baseball-crazy Bogotá, Colombia. With the mention of each new product feature, he was to throw a pitch to professional ballplayers standing in the audience. But one of his tosses smacked a customer in the head. Ballmer jumped off the stage and rushed to the stricken man—who was not seriously injured.

While there are occasional misfires, Ballmer's intensity usually delivers. One example: the sales organization. When he took charge in 1992, Microsoft did little more than advertise, ship products to distributors, and wish them luck. Ballmer segmented the market into six categories—such as consumers and large corporations—and built organizations to address each of them.

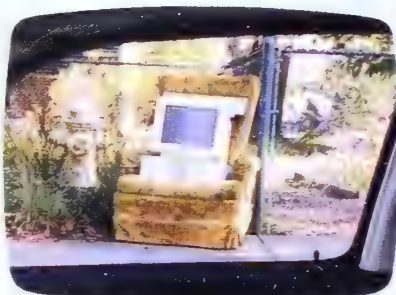
SALES SAVVY. In the corporate market, Ballmer decided that Microsoft should not try to copy IBM's strategy of building huge direct-sales and consulting operations. Instead, it would make allies of thousands of consultants, resellers, and systems integrators who would carry its products to many more customers than IBM could ever reach. "He saw the power of the many," says Judy Sims, CEO of reseller Software Spectrum Inc. The result: Microsoft's enterprise sales organization reached \$4 billion in revenues last fiscal year—up about 40% in each of the past three years.

Ballmer also cultivated the software companies that specialize in enterprise applications, such as manufacturing and inventory programs—persuading them to build their products on top of Windows NT. Says Paul Wahl, CEO of corporate software maker SAP America Inc.: "Steve spotted early that he needed SAP to make NT a success—to demonstrate that it was really ready for prime time." Ballmer offered engineering help, and SAP agreed to port its R/3 suite of enterprise applications to Windows NT. It was a win for both companies: SAP installations that are built on top of NT went from zero to 55% in four years.

Ballmer is relentless when it comes to closing a sale, too. Two years ago, after Boeing Co. told Microsoft it planned to choose Lotus Notes over its Exchange

LIGHTS, CAMERA, SPOOF!

Last year, Gates and Ballmer appeared in a video that was shown at public-relations events. They picked up a Sun Microsystems computer from the roadside—then unloaded it when they noticed a stench



E-mail program, Ballmer called an emergency meeting of salespeople and engineers and told them this would be test of Microsoft's ability to be a corporate computing player. Some 72 hours of nonstop strategizing and software coding ultimately changed Boeing's mind. No longer the aircraft giant is Microsoft's large E-mail customer—putting Exchange on more than 200,000 computers. "It just came down to them committing to make it work," says Daniel Smith, Boeing liaison with Microsoft.

Ballmer has come a long way as manager during his stint in sales. Previously, he ran product development—winning mixed results. After taking over Windows in 1984, he drove engineers relentlessly to meet an autumn, 1985, launch deadline, but when Windows 1.0 was released, it flopped. It took Ballmer more years to produce Windows 3.1, which finally took the world by storm.

People who worked for Ballmer in the 1980s say he didn't understand the development process well enough to manage a product group well. But he has picked up a lot of technical knowledge since then. "The man says he's not technical, but if you tell him something now, he'll remember it at every meeting after that when it comes up," says Richard Tong, vice-president for marketing in the applications division.

But back when the president's position came open in 1992, after Michael Hallman left, the board passed Ballmer over—creating a three-person Office of the President. "There was general agreement between Bill and the rest of us that we wanted him to mature some more—to prove he could handle a large group of people who weren't developers," says board member Shirley.

Ballmer passed that test. Now, he has another mountain to climb as Microsoft's president. While he doesn't have a master plan yet, he wants whatever he does to make the 27,200-person company more nimble. His model is the way Microsoft changed direction to catch up with the Internet wave. "Problem! Brainpower invoked! Solution! Implementation! Go for it!" he says, pounding his fist into his palm for emphasis. "We can just work that way every day and we'll be able to get out ahead."

Ballmer might well be able to keep up that relentless level of intensity. But if he overdoes it, he risks alienating veteran managers who report to him. His challenge is to find just the right mix of urgency and deliberation. And that's got to be tough for a guy who accelerates when he runs up hills.

By Steve Hamm in Redmond, Wash.

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HEALTH CARE

MEDICAL CARE ON A CARD

Can a European import fix what ails America?

It remains an enduring image from the White House's failed campaign for health-care reform: In 1993, President Clinton stood before the nation flashing a mock "health security card." The plan was to link such cards to a national database containing Americans' complete medical histories, promising huge efficiencies and speeding communications between doctors and hospitals.

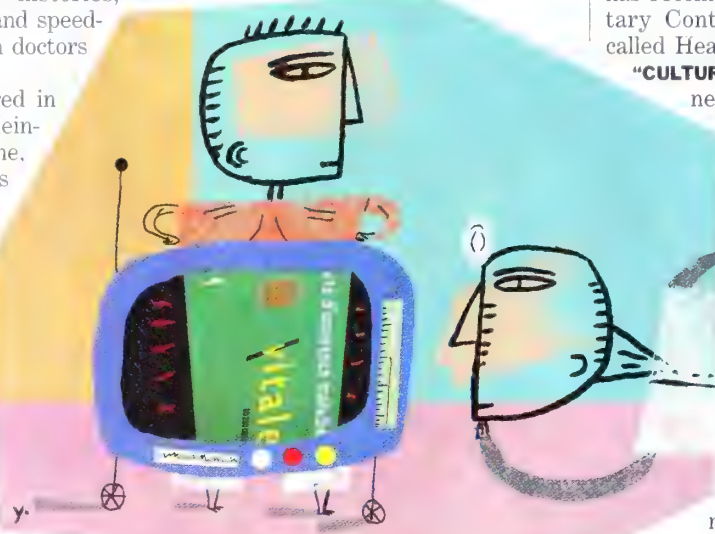
That scheme has sputtered in the U.S.—but not in Dr. Heinrich Fien's office in Karlsruhe, Germany. There, visitors hand receptionist Suzanne Stiegel a smart card—basically, an I.D. card with an embedded chip. Passed through a slot in Stiegel's computer keyboard, the card provides each patient's name, address, and insurance information, all linked to medical files stored in the computer system. After treatment, the system sends an electronic claim to the insurer. No paper forms, no headaches. "This system is so much easier," Stiegel says.

Smart cards have become a staple of European life in the past decade, used for everything from phone calls to betting on horse races. Now, plastic is pushing into health care. Germany has used medical smart cards since 1995, and France, Belgium, and Slovenia are close to instituting similar schemes nationwide. Across Europe, some 200 pilot projects are in the works, forming the backbone of what could become a Continentwide network (table).

BIG SAVINGS. Indeed, about 100 million Europeans will hold medical smart cards by yearend, a figure that should double by 2000, says Cap Gemini consultant Hervé Doaré. While early versions of the French card, to be launched nationwide in 1999, will service only administrative functions, a successor, due in 2000, will bear patients' medical records. Germany's cards soon will include drug

prescriptions, and Holland is equipping ambulances with card readers.

Such systems could produce monumental savings for the Continent's bloated health system, where expenditures are rising faster than gross domestic product. The French government hopes



PATIENTS' PLASTIC

A few of Europe's medical smart-card projects in the works

GERMANY A pilot project records drug prescriptions on a chip card, giving doctors a snapshot medical history

GREECE Three pilots are under way to provide cards for students, the elderly, and children

FINLAND Cards link the elderly and disabled with ambulance services, emergency units, and pharmacies

PORTUGAL Diabetes victims will get cards that track their insulin intake, blood tests, and checkups

DATA BUSINESS WEEK

by 2005 to phase out 8,700 jobs related to paper-based medical transactions, saving \$333 million a year. But health advocates also anticipate that smart cards will foster better medical care. Physicians will get instant access to patients' blood types, allergies, and lab test results, speeding diagnoses. Using search engines to comb through databases of patient records, even doctors in remote villages will be able to locate colleagues handling similar cases to compare symptoms and treatments.

That's why the European Commission is working with local governments to prepare for a coherent, interlinked system and has set up a team to address security and standardization problems. The European Parliament already has recommended distributing a voluntary Continentwide emergency card called Health Passport, in 1999.

"CULTURAL ISSUE." Before a Continentwide network can fly, Europeans must overcome

competing languages and legal systems. Even more daunting are privacy concerns, which vary greatly among nations. Belgians, for example, prefer not to have their insurers' names printed on their cards—so physicians will need special cards to access such data. "This is a cultural issue, which is more complicated than technology and will consequently be slower," says Philippe C.

manager of Santal, a card project co-sponsored by France and the European Commission.

A Continentwide scheme could prove a huge win for the vendors supplying most projects—France's Gemplus, Groupe Bull, and Schlumberger, Germany's Giesecke & Devrient, and Siemens. The companies also hope the European boom will ignite interest in the U.S. Already, the Group of European Nations has launched pilots in North Dakota, Wyoming, Nevada, West Virginia, and Washington, hoping someday to link them to a global network.

It won't be an easy sell, though. Europe leaped into smart cards early because it lacked an advanced telecommunications infrastructure. America's better telecom technology, so smart cards inherently are less appealing. Health-care providers are looking for an economic payback that will justify the huge investment such a system requires. Within two years, the experiments should show how well smart cards translate.

By Inka Resch in Paris



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ANCING

HALT! YOU MAY OWE THE IRS \$500 MILLION

Laidlaw's tax flap has other multinationals worried

to become North America's No. 1 ambulance and school-bus contractor, Canada's Laidlaw Inc. has ridden an outsourcing trend among municipalities and school districts. Tired of the hassle of owning and operating their own vehicle fleets, many have turned to Laidlaw to transport patients and children. The strategy has helped revenues soaring five-fold, to \$3.1 billion today. And to fund the rapid growth, Laidlaw hit on a clever tax arrangement. To buy out competitors in the U.S., where the carrier accounts for 90% of its business, the Kingston (Ont.)-based company used low-cost financing arranged through a subsidiary in a European tax haven. But Laidlaw just hit a major speed bump. The Internal Revenue Service is charging the company pushed a large offshore financial maneuver over the line and took advantage of tax breaks. If the case holds up in court, Laidlaw admits it will owe as much as \$500 million in back taxes and interest—one of the steepest tax awards in histo-

ry. That would swallow almost all of its 1997 operating income of \$617 million. Bad enough, but the case also has big implications for other foreign multinationals. The allegations have sent a chill through these companies doing business in the U.S. Many of them use similar financing for their American units, and they fear the IRS could hit them next. Says accountant Charles Taylor of DeLoitte & Touche: "No one wants to be in a Laidlaw situation." He and other tax accountants are scrambling

to see if their clients are vulnerable to IRS scrutiny.

Accountants say the agency has questioned several Laidlaw-like arrangements during routine audits in recent years, but so far it appears Laidlaw is a special case. "What these guys tried to do with the tax code is off the charts," says Robert Willens, Lehman Brothers Inc.'s tax expert. Nevertheless, they're not alone. Europeans are fond of the setup, Canadians more so. KPMG Peat Marwick partner Bill R. Lawlor estimates that half the Canadian outfits with U.S. subs use it.

YELLOW FLEET. The Laidlaw dispute stems from the mid-1980s, when it kicked off its growth plan after starting out as a small trucking outfit owned by Michael DeGroote, a gruff entrepreneur who made a fortune in construction. He got the company into school buses and garbage hauling before leaving in 1990. Current CEO James R. Bullock joined in 1993 and quickly sold the waste division. Today, the Laidlaw name is on the sides of 37,000 school buses.

Rather than fund the acquisition-led growth at its two main U.S. subsidiaries directly from its own coffers, Laidlaw used intra-company loans. That way, the American subsidiaries could deduct interest payments on their U.S. tax returns. The main source of the borrowings was a wholly owned financing unit, Laidlaw International Investments, set up in the Netherlands to benefit from low tax rates on foreign finance facilities.

Eventually, the borrowings by Laidlaw's U.S. subsidiaries—Laidlaw Transportation Inc. and Laidlaw

THE CASE AGAINST LAIDLAW

According to the IRS, the Canadian company...

MADE DUBIOUS LOANS A Laidlaw finance affiliate in the Netherlands shipped almost \$1 billion in capital to its struggling American operations. But unlike a real loan, the feds say, the principal wasn't repaid on maturity.

REFUNDED INTEREST Although the U.S. subsidiaries paid interest to the Dutch affiliate, the money was immediately refunded back in the form of new loans.

TOOK TAX DEDUCTIONS Laidlaw's U.S. subsidiaries deducted the interest payments from their U.S. taxes. By law, only interest on bona fide loans is deductible.

Industries Inc.—swelled to hundreds of millions of dollars a year. Those sums attracted the attention of the IRS. In a claim filed four years ago, the agency said the loans to the U.S. units weren't real loans, since they didn't pay back the principal on the maturity date. The IRS also says the subsidiaries got their interest payments refunded almost immediately, labeled as fresh loans. Further, the IRS says the U.S. units lacked the financial means to handle the debt, due to weak cash flows. Its conclusion: If the loans were really just capital infusions from parent Laidlaw, they weren't eligible for tax deductions.

Laidlaw filed suit last September to block the IRS claim. Neither the company nor the IRS will comment on the tax imbroglio. DeGroot did not return calls. In legal filings, the company argues that the Dutch loans are bona fide debt.

Laidlaw, in the court papers, says the IRS is looking at its offshore financing the wrong way. The loans weren't repaid at their 1989 maturity, the company says, because this was a routine rollover. And a tripling of cash flow from 1986 to 1988 proves that the U.S. units were in better financial shape in the 1980s than the IRS makes out, Laidlaw contends.

On June 30, though, U.S. Tax Court Judge John O. Colvin rejected that reasoning on the grounds that the maturity date was mere "window dressing" to make the investments look like debt. Plus, real loans don't involve the instant return of interest payments to the borrowers, he wrote—a point Laidlaw doesn't contest. Colvin also argued that all the cash flow was needed for expansion, leaving nothing for debt service.

BIG KITTY. Laidlaw lost that opening round when Colvin disallowed the deduction on \$975 million in loans made from 1986 through 1988. His decision, which the company intends to appeal, hit Laidlaw with a \$141 million judgment. Next, both sides will duke it out over similar IRS claims for 1989-1991, then 1992-94. Those claims could run the tax tab up to \$500 million, CEO Bullock has stated in a news release. He also said the IRS may go after post-1994 deductions. If so, the liability may soar.

How will Laidlaw cope? Nervous investors have knocked the stock down 28%, to around 9. Nevertheless, the U.S. divisions are now solidly profitable and the company has amassed a \$200 million kitty to pay off the IRS. But depending on the outcome in tax court, that could be merely a downpayment—and there may be more cases to come.

By Larry Light in New York

STRATEGIES

LOOK OUT, SUPERMARKETS—WAL-MART IS HUNGRY

Its "experimental" stores already have grocers running scared



BIG IDEA: Stocking up at a Wal-Mart supercenter in Moore, Okla.

When Wal-Mart Stores Inc. recently announced plans for three "experimental" grocery stores in Arkansas, industry executives shuddered. After all, only a decade ago, Wal-Mart said it was merely testing giant "supercenters" that combined food and general merchandise. Today, its supercenters number nearly 500—and after ringing up grocery sales estimated at \$12 billion this year, the Bentonville (Ark.) company will rank as the country's eighth-largest grocer.

With that kind of track record, it's no wonder that the new Wal-Mart Neighborhood Markets, to open in October, are drawing plenty of attention. The 40,000-square-foot stores, about the same size as traditional supermarkets, are one more sign of Wal-Mart's determination to dominate this highly fragmented \$415 billion business, as it has the discount-store industry.

"TERRIBLY THREATENING." By leveraging its distribution and buying strengths, Wal-Mart is hoping the new markets will be able to beat grocery stores with lower everyday prices while offering more conveniences than its supercenters. That's why few are fooled by the small-scale start: If the test stores meet prof-

it targets, Wal-Mart will likely roll out new format out nationwide. "Any supermarket executive that looks at the latest development should be very concerned," says retail expert Philip Georges, managing director at Peat Marwick. "What it says is one way or another, we're going to win and get your customer."

Already, Wal-Mart's push into groceries is pressuring giants like Kroger Co. and Safeway Inc. to cut costs and boost service. And the pressures are coming just from the supercenters: All food and other grocery items sold through the Wal-Mart discount Sam's Clubs units, and retail consists of James M. Degen of J.M. Degen & Co. in Templeton, Calif., estimates that groceries now account for more than \$1 billion of Wal-Mart's total \$118 billion in sales. Wal-Mart "is totally flattening the grocery industry," warns Gary Stibel, principal of New England Consulting Group in Westport, Conn. "It's terribly threatening." He predicts that in 10 years, Wal-Mart and Safeway will be the two largest food retailers in the U.S., leaving such rivals as Kroger and Albertson's Inc. in the dust.

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The Corporation

look like an even more direct assault on traditional grocery chains. Wal-Mart executives insist the three stores—plus two on the drawing boards—are only a test. But many analysts already predict the smaller stores will quickly prove a powerful complement to the giant supercenters, which average 182,000 square feet. Stibel thinks the new format alone, if it's rolled out nationally, could grab 5% to 10% of grocery volume in the U.S. within 10 to 12 years.

That's not to suggest that Wal-Mart is tapped out with its supercenters, where about one-third of the space is devoted to groceries. Indeed, Wal-Mart Executive Vice-President Nick White, who oversees the \$26.5 billion operation, says that the company will add 120 to 130 supercenters a year in the U.S. "indefinitely." Most will replace smaller discount stores. Potentially, he adds, "every Wal-Mart store could be a supercenter." The retailer now operates about 1,900 conventional discount outlets in the U.S.

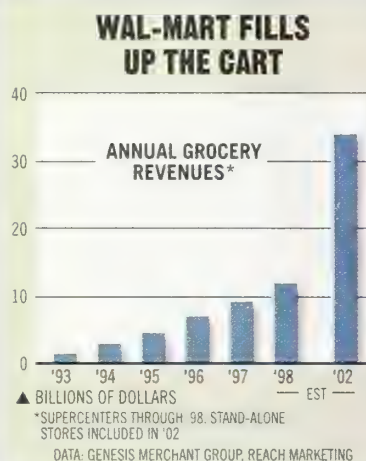
But even as it adds new prototypes to its portfolio of supercenters—the latest being a 200,000-square-foot model in Broken Arrow, Okla.—Wal-Mart is trying to bite into a new part of the market with the Neighborhood format. St. Georges notes that only 25% to 30% of grocery shoppers are motivated primarily by low prices, which is Wal-Mart's strong suit in the supercenters. Many other consumers put convenience at the top of their shopping list. With their huge size and reach—sometimes drawing customers from up to 60 miles away—the supercenters don't always hit the mark.

CROWD CONTROL. Consider the shoppers avoiding Wal-Mart's spanking new supercenter in Broken Arrow, a suburb of Tulsa, on a recent August day. Despite mouth-watering piles of fresh produce near the entrance, a display case filled with take-home meals such as calzones and tamales, and lots of grand-opening specials, Kristin Capeheart, 29, and her boyfriend Brian Garrett, 24, are shopping at their usual store—Albertson's, several miles down the road. "We don't like to go there if we don't have to," says Capeheart. "There's too many people."

Moreover, a Reasor's Food Warehouse store on the same street stocks a variety of fish and fancy breads that can't

be found at the supercenter. Mary Brawley, 43, notes that four employees of this family-owned chain have offered to help her in the past hour. "Go find someone [to help you] in a superstore," she scoffs.

To lure in recalcitrant shoppers, Wal-Mart's new format is designed to look a lot more like a traditional supermarket. And the good news is that it's a low-risk proposition. By planting the new stores near existing supercenters, the company can use the same sophisticated food-distribution system that supports the big stores. Wal-Mart recently opened in



Bedford, Pa., its eighth food-distribution center, with another to be added later this year. These mammoth 800,000-square-foot facilities boost efficiency by enabling Wal-Mart to deliver dry groceries and fresh products from the same location.

That alone should help Wal-Mart put the squeeze on competitors in this traditionally tiny-margin business. And borrowing from the techniques that have allowed it to dominate in discounting, Wal-Mart also has many of its grocery items on "automatic replenishment," with computer systems helping to refill shelves as needed. The company now supplies virtually all of its own groceries, giving it a cost advantage over the many rival grocers that use third-party wholesalers.

As a result, most analysts expect the Neighborhood Markets to compete heavily on price when they open up. But it won't be their only selling point. The system also enables Wal-Mart to ensure fresher products and adequate supplies.

"That puts us miles ahead of the bulk of the 35,000 grocery stores we compete with," says White.

It should also provide a juicy payoff. Wal-Mart believes its investment return on the small stores could be as good as it is on the supercenters. Burt P. Flicinger III, managing director of Reach Marketing in Westport, Conn., figures the supercenters achieve a high 25% return on investment, compared with 20% to 22% for grocery chains and about 22% for conventional discount stores.

FEAR AND LOATHING. Competitors, of course, are hardly waving the white flag. Noting that most major supermarket chains no longer open stores as small as the new Neighborhood Markets, one grocery industry rival points out that there's a reason why the median-size new grocery store is no larger than about 52,400 square feet. Wal-Mart "cannot get the assortment that's necessary in the store," he says. White of Wal-Mart says the retailer hasn't yet decided how many products the new store will carry, but that it will include fresh foods, health and beauty aids, and other traditional grocery categories.

Still, many in the industry aren't taking any chances. Wal-Mart's grocery expansion is one reason behind the flood of recent industry mergers, such as the marriage of Albertson's and American Stores or Safeway and Vons. The mergers are supposed to slash distribution and administrative costs while bringing up the combined chain's market clout. That could pit Wal-Mart against much stronger grocery competition. The likely losers? The smaller chains and independent stores which simply won't be able to spread their costs over enough volume to compete with the giants. "Most of the regional players will go away," warns consultant Stibel.

Already, those pressures are starting to play out. R. Randall Onstead, CEO of 116-store Randalls Food Markets Inc. in Texas, admits he's feeling heat from six Wal-Mart supercenters in his territory. And the new Neighborhood Market concept is clearly a threat. "Whatever they do, they've proven to me they can do it right," he says. These days, no one's underestimating the new grocery giant.

By Wendy Zellner
in Broken Arrow, Okla.

Wal-Mart's grocery expansion is one reason behind the recent flood of mergers in the industry



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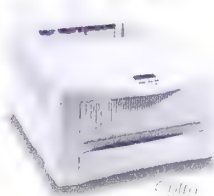
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Special Report

ENTERPRISE

Timely Insights for Small Business

Box page 2

at Bits Deterring employee lawsuits, credit
rks on the Web, company discounts, and more

Technology page 4

ugging Y2K Planners
l to worry about their suppli-
systems as well as their own

ches in Time Clocks,
ating systems, software,
: Be sure to check 'em all

ne or Horror? A poll to
now you're handling the Year
nuisance. Or nightmare



Companies page 10

Rare Bird Andy Wilson's
focus on people—employees
and clients—has been critical
to Boston Duck Tours' success



Marketing page 14

ne Going Small companies have been slow to
on the diversity marketing bandwagon, but
asier than it looks, and needn't be expensive

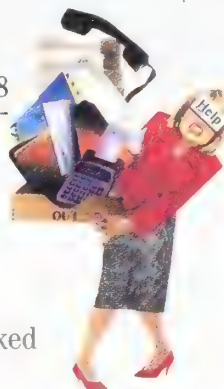


People page 17

Nanny's Little Baby British
baby nurse Jean McGraw raised a
strapping startup from a family
shortbread recipe

Management page 18

Virtual Outsourcing Cyber-
space services offer speed,
convenience, and lower costs



Education page 22

No Local Yokel Often overlooked
and undervalued, community col-
leges can offer a treasure trove of resources



Buyer's Guide page 26

Get-Busy Signal New long-
distance telephone fees make it a
good time to shop around again

Downtime page 30

Sound Advice Music, however
you define it, is becoming an office standard.
Etiquette is one issue; repertoire is another

INBOX

EDITED
BY
EDITH
UPDIKE



"YOU HAVE THE RIGHT TO BE FIRED..."

Win or lose, lawsuits brought by fired employees can cause serious damage to your company. How to deter them? If workers understand the limits on their rights from the start, they are less likely to file vindictive suits, employment lawyers say. The problem is, most overestimate their legal protection. A recent study by Pauline Kim, associate law professor at Washington University, found 89% of 337 job-seekers with recent work experience thought it was illegal to fire an employee out of personal dislike. (In most states, a worker can be fired for any reason except discrimination or refusing to break the law.)

One way to manage expectations—and firm up your legal ground—is with carefully written materials. Company documents, such as an employment offer, policy manual, or performance review, should avoid the words "permanent" and "just cause," which suggest management's rights are limited. Kim found that the percentage of those who think it is illegal to fire someone for a cheaper replacement drops from 82 to 63 if a company's policy states "we retain the right to discharge employees at any time, for any reason, with or without cause."

MANY BEAN COUNTERS, ONE POD



It's no use linking computer hardware in a work if your software can't network, too. In June, way behind competitors Peachtree Software and Best!Ware, Intuit finally added networking features—which let many users work with the same program and data at the same time—to its popular accounting software, Books Pro. All three companies' programs



SOME TIPS FROM THE BIG BOYS

Most corporate giants guard their secrets closely. But a few do share, offering training courses to the public:

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MOTOROLA UNIVERSITY: Six courses, of a few hours each, on quality control, product development, and other issues, at four U.S. locations. \$150-\$1,900. (847 576-6000 or motorola.com/mu)

LIFEDESIGNS: Two-day seminars designed at Avon on developing a strategic life plan, aimed at professional women who are busy for time. (This division was

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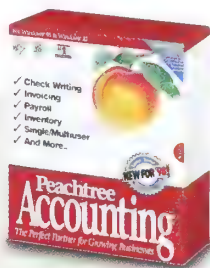
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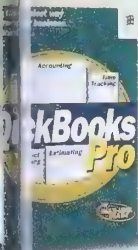
SMALL FRY FINISH FASTER

Dauids beat Goliaths at turning out new products, says a study by the Product Development & Management Assn. (PDMA). Small companies create products faster (23 months vs. 30) and have more successful products (62% vs. 58%) than big ones. That's good, as innovations are also more important to small companies, accounting for 38% of sales (vs. 27%) and 36% of profits (vs. 24%). But the process is often haphazard, and formal procedures can help identify lemons sooner. For more info, see PDMA's Web site (pdma.org).



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SO THEY SAY

"I'm not anti-capitalism, but the human element isn't taken into account enough."

—Andy Wilson, founder of Boston Duck Tours, on his management philosophy (page 10)

to's creator, 24-year Avon a'ail Blanke, last May, but er ars themselves have not \$395. (800 752-7314 or s.com)

OF ORLANDO



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OVERNIGHT DELIVERY SERVICES	37
HEALTH INSURANCE	33
HOTELS	30
COMPUTERS/PRINTERS/ETC.	27
CAR RENTALS	26
AIRLINE TICKETS	26
GASOLINE	16

DATA: AMERICAN EXPRESS

WAKE UP AND SMELL THE DISCOUNTS

Can you get more for less? Probably. A poll by American Express indicates that most small-business owners (91%) are getting some discounts, but they're not going about it methodically. Nearly 60% of 325 respondents couldn't think of any discounts aimed at small biz without prompting from an interviewer,

and 70% said they didn't know where to find information on discounts. One-tenth receive discounts solely on telephone service, and although 60% say health insurance discounts would be very helpful to them, only 33% get lower rates. Also, fewer than 20% could say without prompting what specific products or services they got at reduced rates or how big the reductions were. (Sometimes a discounted rate isn't properly billed, so it

CHEAP AND CHEAPER

In a poll, 325 small biz owners were asked: What's the average discount your company gets on goods and services overall?

PERCENT OF SMALL FIRMS	AVERAGE DISCOUNT
21%	LESS THAN 5%
16	5
19	10
12	15
7	20
9	MORE THAN 25

DATA: AMERICAN EXPRESS

pays to keep track.) Most negotiate on their own (66%), but 18% go through associations, trade groups, or an outside firm.

THE Y2K BUG: LOOK BOTH WAYS

To tell clients you're ready, your suppliers must be, too

Bill Howell had heard about problems related to the Year 2000 bug, but he didn't expect them to crawl right out of his mailbox. Howell, owner of Howell Petroleum Products Inc., a nine-employee petroleum-products distributor in Brooklyn, N. Y., has received some 10 letters and questionnaires from suppliers, clients, and banks in recent months—each wanting assurance that he has prepared for the Year 2000, or Y2K, computer glitch. As you've probably heard *ad nauseum*, that's when many antiquated two-digit-date computer systems roll 99 back to 00, potentially sparking a meltdown of disastrous proportions. For Howell's business—and yours—proof of readiness for the changeover may be crucial in maintaining hard-won business relationships.

"Initially, it scared the hell out of me," says Howell, who, after checking with his computer manufacturer, is confident his four PCs are "Y2K O.K." Howell has been returning the questionnaires, some of which require only a signature, while others need longer responses. "The letters kept coming, and I've been told they're going to keep on coming," he says.

Indeed, at the time the Y2K glitch first appeared on the media's radar screen two years ago, Corporate America was thinking it needed to wrestle only its own systems into shape. But planners soon realized they also had to worry about whether their suppliers—and their suppliers' suppliers—ad infinitum,

were prepared to battle the bug.

Already, corporate Y2K demands are starting to influence the simplest of commercial transactions. Contemplating a line of credit? Bidding on a job for a multinational? Maybe you're receiving customer orders via modem. Whatever the task, you'll most likely have to eventually demonstrate to your clients, vendors, and the local bank that your computer systems won't have any date-related breakdowns when the clock strikes midnight.

Small companies have similar worries. "If my major suppliers are totally computerized and their systems don't work, then I'll have a problem," says Emily A. Williams, owner of Williams Tile Co., a 30-employee construction company in Florissant, Mo., who is waiting for a manufacturer's upgrade of her customized accounting software.

A recent National Federation of Independent Business study found that 82% of small businesses have potential exposure to the Y2K bug. However, out of 500 small outfits surveyed, just half said they had already taken action or had plans to do so. In the worst case, the study concludes, Y2K woes could shut down as many as 330,000 small companies. "The range of consequences is enormous," says the study's author William J. Dennis, Jr., a senior research fellow at the NFIB.

The pressure to ensure that suppliers are compliant is further intensifying now that the Securities & Exchange Com-



mission has required public companies and the 50,000 local governments that issue bonds to disclose their third-party Y2K liabilities.

"We're looking at our entire infrastructure," says Ken Ouchi, chief information officer for Solecron Corp., a \$1.3 billion electronics manufacturer in Milpitas, Calif. The company recently canvassed more than 4,000 suppliers about their Y2K preparations. If those answers give the company reason to suspect a vendor's internal systems could crash, Solecron will line up emergency suppliers. "We can't afford to have an outage because a critical supplier goes down," says Ouchi.

Banks, which are being pushed by federal regulations to minimize the Y2K impact, are starting to move small companies into compliance, too. Arkansas State Bank in Clarksville, Ark., recently added Y2K questions to its loan applications to flag any problems that could cripple a business and affect its loans.

WRITE YOUR OWN: Experts advise drawing up a standard statement outlining your company's plans and progress to date, without guarantees—and having a lawyer review it



treating them as adversaries. Also, be honest with clients, but don't make promises you can't keep, such as guaranteeing compliance by a certain date, says Joshua Slavitt, an attorney to high-tech companies at Philadelphia's Synnestvedt & Lechner. "It could come back and haunt you."

"PANICKED." While some Y2K survey forms ask dozens of detailed questions—such as how much you're spending on Y2K compliance and whether you have a written timeline—Slavitt and other legal experts recommend drawing up a standard Y2K response that outlines the company's Y2K plans and its progress to date. Ask a lawyer to review it, too. "Don't pay any attention to what's in the survey, and use the statement across the board," recommends William A. Fenwick, a partner at Fenwick & West, a Palo Alto (Calif.) law firm that handles Y2K issues. "If you check a box and send it back, you're making a very absolute statement," Slavitt cautions.

Of course, your own roster of suppliers is also putting your company at risk. Randall York, president of FallLine Corp., a 27-employee polyurethane molder in Reno, Nev., was lucky enough to get his 15-year-old custom accounting-and-inventory system upgraded by the developer for \$600. But he's still anxious about how prepared his large chemical suppliers are. Although he has sent out six of his own compliance letters, no one has responded so far. "A lot of them are very panicked," he says.

Running your own Y2K survey, as York did, could help you assess your Y2K bug exposure (see a sample form at enterprise.businessweek.com). But be wary of guaranteeing your suppliers' readiness to others, says CoreTech's Costello: "I don't see a lot of companies promising that."

As the Year 2000 creeps closer, promises will go only so far. Survival in this fragile business biosphere will require equal measures of trust and trepidation.

By Dennis Berman in New York

Join Ed Yourdon, author and Y2K expert, for a live chat on Sept. 13 at 9 p.m. EST. Go to America Online at keyword: BWTalk.

Loan officer Coral L. Gould has been visiting small-business clients to ensure they're protected against potential Y2K shutdowns. "Companies need to think outside their walls about who is going to be affected," advises Gould, who says the bank might revoke credit from computer-dependent companies that don't demonstrate compliance. "Some of them didn't have a clue, and we told them that they should be concerned," she says. To help avoid surprises, Gould hands out pamphlets and even suggests that companies take out additional loans to pay for needed software upgrades.

Small-company owners say they understand the technical reasons for inquiries about their Y2K battle plans, but they're afraid their responses could be used against them in a lawsuit alleging they misrepresented their preparedness.

"Everyone is playing this very carefully because of the threat of litigation," notes Ouchi, who estimates that just 10% of the 4,000 surveyed vendors have re-

sponded to the company's requests. In general, return rates by businesses on such surveys have been running less than 20% across all industries, adds Thomas Costello, a consultant at CoreTech Consulting Group Inc., which consults on Y2K issues in King of Prussia, Pa.

But as Costello and other Y2K experts point out, most small companies can't afford to ignore Y2K queries, especially if huge clients are threatening to yank their business. Howell received a Y2K compliance letter from South Jersey Gas Co. that warned vendors that if they didn't respond, the utility "will assume your company will not be Year 2000 compliant, and will therefore not meet our standard" for suppliers.

How should you respond to the deluge of Y2K compliance demands in a way that will fix any glitches, keep your customers happy, and limit your legal liability? First off, don't lose sight of the mission at hand: squashing the Y2K bug. That's best done by cooperating with clients, not

HOW TO ZAP THOSE YEAR 2000 BUGS

Taking precautions now will save you big headaches later

Time marches on, and before you know it, the Year 2000, with its potential problems, will be a reality. Here are some things you can do to ensure that your business and computers will be ready for the new millennium.



Time clocks, operating systems, software, data—be sure to check them all

In general, most newer Pentium systems should work in 2000, while many older Pentium systems, along with 486, 386, and 286-based systems, probably won't. But before you run any computer-related tests, be sure that you back up the applications and data on your system's hard drives. There is a remote chance of mishaps when you are performing date-related tests—particularly if you are running specialized software that relies on the date as a way of verifying its license or maintaining its audit trails. In that case, contact the software's publisher for suggestions before proceeding.

CHECK YOUR PC'S REAL-TIME CLOCK AND BIOS

The Real-Time Clock is a device in your computer that tracks time. BIOS (Basic Input Output System) is internal system software that controls computer hard-

ware and determines the compatibility of your system. If your system's time-keeping clock (along with the BIOS) can't make the rollover to 2000, all of your computer's functions that relate to dates will be thrown off. To test your PC's real-time clock and BIOS, you can try the following:

1. Back up your PC.
2. Bring up your system's DOS prompt (in Windows 95 or 98, you can click on Start, Programs, and then MS-DOS prompt, or press F8 as your system is booting to start your system in Safe Mode, and then tell your computer to present a DOS prompt).
3. Type "Date" and press Enter. This brings up the date function in DOS.
4. Change the date to 12-31-1999 and press ENTER to change your computer's date to December 31, 1999.
5. Type "Time" and press ENTER.
6. Change the time to 11:58:00 p.m.
7. Shut down your computer.
8. Wait a few minutes and then turn your computer back on.
9. Once again, bring up your system's DOS prompt, type "Date" and press ENTER. If the function displays a current date of 01-01-2000, your system's real-time clock will work in 2000. If the date displays as 01-01-1980, 01-01-1900, or something else, your system won't work properly in 2000. In that case, you'll need to check with the manufacturer of your system and/or motherboard to see if you can upgrade the BIOS.
10. Repeat steps 2 through 6 to reset your system back to the correct (current) time.

CHECK YOUR PC'S OPERATING SYSTEM

The operating system is a specialized software program that allows a computer to perform basic tasks with files, disks, and memory, and accepts input from the mouse and keyboard. It's the core program that defines how your computer works and what programs it can run. Popular operating systems include Windows 3.x, Windows 95, Windows 98, Windows NT, OS/2, and UNIX. To test your computer's operating system, you can try

the following, but be sure to check Y2K compliance data all OS manufacturers have on their Web sites:

1. Back up your PC.
2. Follow steps 2 through 8 of "Check your PC's real-time clock and BIOS" (above).
3. Check the date in your computer's operating system. If the date function in your operating system displays the year 2000, it should work in 2000. To verify this in Windows 95 or 98, you can click on Start, Settings, and then Control Panel and then double-click the Date/Time icon. If, on the other hand, the date displays 01-01-1980, 01-01-1900, or something else, your system won't work in the year 2000, and you should consider upgrading

to the latest version of your operating system that will. Check with the publisher of your operating system.

4. Repeat steps 2 through 6 in "Check your PC's real-time clock and BIOS" to set your system back to the correct (current) time.

CHECK YOUR SOFTWARE

Nearly all commercial PC programs store dates after 1999 correctly, though some old DOS ones don't. A bigger issue is how they interpret years entered with two digits. Will a pensioner's birthyear of '28 be assigned correctly to this century or to the next? Even about his Treasury bond, maturing in '28—that is, 2028? Almost all applications use the same strategy for dealing with this problem: A two-digit year

Will your credit cards work in 2000? It can't hurt to ask the issuers



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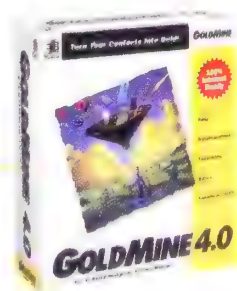
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that is, how they will be affected by the change. Even so, it is essential to make a plan for the company's year 2000 compliance. Companies are already beginning to make plans for the year 2000. Some are already beginning to make plans for the year 2000. Some are already beginning to make plans for the year 2000.

For more information on the year 2000 compliance, contact the Federal Reserve Bank of New York. Some of the information that they can provide includes: a list of the states that have enacted legislation regarding the year 2000 compliance; a list of the states that have enacted legislation regarding the year 2000 compliance; a list of the states that have enacted legislation regarding the year 2000 compliance.

CHECK YOUR DATA

Even if you have a backup system in place for the year 2000, there's no guarantee that the data you have is accurate. Even if you have a backup system in place for the year 2000, there's no guarantee that the data you have is accurate. Even if you have a backup system in place for the year 2000, there's no guarantee that the data you have is accurate.

CHECK YOUR BANK

Contact your bank to make sure that they are ready for the year 2000 compliance. Find out if your bank has a year 2000 compliance plan in place for the year 1998, so it will have more time to



Make sure utilities and other service providers are ready for the switch

find and repair any potential problems.

CHECK YOUR CREDIT CARDS

Contact all credit-card-issuing companies to ensure that they have reprogrammed and tested their systems for the year 2000. If you already have to reprogram your card with an expiration date of 2000 or beyond, you can probably assume that the credit-card company has made the year 2000 issue that it

never hurts to verify it by calling and, ideally, getting it in writing.

CHECK YOUR INSURANCE CARRIER

Talk with your insurance company to be sure that they are ready for the year 2000. If possible, see if you can get any assurances in writing. Some states may be able to provide some of this information through your state's insurance department.

CHECK YOUR VENDORS

Contact all of your vendors to find out their ordering and shipping terms will work in 2000. If possible, get their compliance in writing. If it can be arranged, have the company provide you with test results and have its staffers work with you to process a test order that will be due in 2000.

CHECK YOUR OUTSIDE SERVICES

Get in touch with all of the companies that provide services to your business, including utilities (water, gas, electricity) as well as services (repairs, maintenance, and more). Since they can end up passing a lot of companies, you may want to check first with the ones that are crucial to the operation of your business. If possible, get their compliance in writing and ask to see test results. If possible, see if you can arrange with the company to process a test order in time for the year 2000.

By Wayne K. Brown in Los Angeles

Y2K: TOTAL HYPE OR TRUE HORROR?

Fill out and fax us at 1-800-500-3758 or e-mail online at entbiz@entbiz.com your answers to these questions.

1) How many employees do you have?

- | | |
|----------------------------------|----------------------------------|
| ☐ 0-9 | ☐ 100-199 |
| ☐ 100-199 | ☐ 200-299 |
| ☐ 200-299 | ☐ 300-399 |
| ☐ 300-399 | ☐ 400-499 |
| ☐ 400-499 | ☐ 500-599 |
| ☐ 500-599 | ☐ 600-699 |
| ☐ 600-699 | ☐ 700-799 |
| ☐ 700-799 | ☐ 800-899 |
| ☐ 800-899 | ☐ 900-999 |
| ☐ 900-999 | ☐ 1000+ |

2) How much of your business is Y2K sensitive?

- ☐ none
☐ somewhat sensitive
☐ all sensitive

3) How much of your business is Y2K sensitive?

- ☐ none
☐ some
☐ most

4) What have you done to prepare for Y2K?

- ☐ ignored them
☐ answered a questionnaire
☐ sent out standard response
☐ answered verbally
☐ altered software or hardware

5) How many of the companies you do business with have prepared for Y2K?

- ☐ none
☐ some
☐ most

6) What type of equipment have you used for Y2K?

- ☐ PCs
☐ software
☐ other computerized equipment
☐ customers' (i.e. credit cards, billing)
☐ vendors' (i.e. bank, utility payments)
☐ none

7) Which of your vendors are Y2K sensitive?

8) How much of your business is Y2K sensitive?

- ☐ PCs
☐ off-the-shelf software
☐ customized software
☐ other computerized equipment
☐ none

9) Could your staff handle it, or did you need outside help?

- ☐ in house
☐ consultants
☐ a mix of the two
☐ haven't done anything yet

10) How much did you spend?

- ☐ nothing
☐ under \$1,000
☐ \$1,000-\$5,000
☐ \$5,000-\$10,000
☐ more than \$10,000

11) How many people did it take?

- ☐ fewer than one
☐ 1-4
☐ 4-10
☐ 12-24
☐ more than 24



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A NICE BUSINESS BUILT ON BEING NICE

Generosity is the hallmark of thriving Boston Duck Tours

A lot of experts tell Andrew Wilson he doesn't understand business: His prices are too low, his pay scale too high. But the 41-year-old founder of Boston Duck Tours, which offers land/water sightseeing trips in World War II-era amphibious vehicles known as DUKWS, or "Ducks," has built a flourishing company in just four years by swimming against the current. "Other businesspeople don't get it," he says. "Why argue with success?"

Why indeed? Buoyed by Boston's recent tourism boom, Wilson has made his entertaining tours stand out—even in a market so cut-throat that tour-ticket vendors have been known to fight over customers on Boston Common. His colorful flock of 16 Ducks, bearing proud local names such as Kenmore Carla and Fenway Fanny, take visitors on a fun yet fact-packed trip that

cruises along the Charles River as well as around the city's fabled sights.

The 80-minute excursion costs adults \$20. Boston Duck Tours carried 300,000 passengers from April to October, 1997, when the Small Business Administration named Wilson Massachusetts Entrepreneur of the Year. That traffic produced revenues of \$4.4 million—and profits of \$900,000—even though school groups get discounts and Wilson gives away thousands of free

MANAGEMENT

Human Capitalist

Andy Wilson's focus on people has been critical to Boston Duck Tours' success.

WHO	WHAT HE GIVES THEM	THE PAYOFF
EMPLOYEES	Good wages and year-round benefits in a seasonal business	Happy guides mean happy tourists; less turnover
TOURISTS	A lighthearted historical tour for less than he could charge	Customer word-of-mouth is his chief form of marketing
CITY LEADERS	Support for education, river cleanup, and charities	Creates goodwill with officials who control permits and routes
COMMUNITY	Free tickets to kids and veterans; sponsorship of local events	It generates press coverage and more word-of-mouth

ENLIGHTENED BOSS
"Ultimately, this business is about people," says Wilson. "If they're enthusiastic, it works"

tickets. Revenues are expected to pass \$5 million in 1998.

But what makes this former investment banker president a duck? The bird is the way he operates. Wilson

won't raise prices, even though he's turned away 250,000 customers last year because of limited capacity. (The city gave him permits for 4 more Ducks this year, up from 12. He has asked for more.) "It'd be greedy," says Wilson, who relies on word-of-mouth and customer satisfaction to generate business. "People remember when you've got them." The situation has made Boston Duck Tours a B-school case study at Harvard University, the professor thought he should expand out of Boston. But Wilson thinks the city's calm river and compact historical district are uniquely suited to the business.

PRACTICAL. Then there's his attitude toward profits. Last year, he donated 15% of pretax profits, or about \$90,000, to community projects such as cleaning the Charles. He also paid out about \$1 million in bonuses—to everyone but himself. His own salary is "significantly under six figures," he says. Managers own 1.5%-to-3% equity in the business after five years, and after three months, all 30 or so employees enjoy benefits almost unknown in seasonal work: year-round medical, dental, and life insurance, plus 401(k). Such largesse is practical, Wilson argues, citing the success of employee-oriented Southwest Airlines Co.: "Ultimately, this business is about people. If they're enthusiastic, it works."

Enthusiasm is definitely on display aboard the Ducks. Each driver/guide, or "conductor," develops a theatrical

personality, costume, and stage spiel—Brad Rigby, for example, calls himself "Ace Bandage" and dresses like a New England Patriots football player. But besides encouraging wackiness, the crew carry kazoes to quack at passersby who often reply in kind—the company insists employees know what they're talking about. Guides study with the local history society, for example. And they're w

THE BAKERY FOR DOGS

Dan Dye and Mark Beckloff
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ENTERPRISE

Companies

paid. The highest-earning conductor made more than \$50,000 last year—for eight months' work. Even the part-time, mostly student, ticket-takers earn a \$1-an-hour bonus on top of their \$9-an-hour wages if they stay through their contracts.

Wilson says the generosity reduces labor costs by cutting down on turnover. (All four of the original conductors are still aboard.) Recruiting is also easier. Brad Rigby came from a rival tour company that runs trolleys year-round but offers no benefits. "I'm not gonna leave

as \$500, and then came the hard part: a two-year odyssey through "100-hour government" to get the 30 permits needed to launch in late summer '95.

Then Boston Duck Tours hit rough water. Wilson, \$270,000 in debt, \$80,000 the first year. But his wife crew pitched in to keep the startup afloat—painting, wiring, and laying carpets in the office themselves. Wilson spent nothing on advertising, figuring correctly, that he didn't need it; the media gave lots of play to the diverse newcomers. Revenues rose to \$1.9



ON THE CHARLES

Last year, Wilson gave 10% of pre-tax profits to help clean the river. He also paid out \$1 million in bonuses

in '95, and his business has been making money ever since. "The investors are very pleased," says Jeffrey S. Cormick of Satellite Asset Management.

here unless they make me," he says.

Wilson hatched the idea for the company in 1992 when he saw tourist-bearing Ducks lumbering around Memphis. He had recently bailed out of "100-hour workweeks" as a vice-president for operations at investment-banking firm Boston Co., feeling, among other things, underpaid for his contributions. "I just hit a wall one day," recalls the Chicago native, who put himself through college working nights as a deputy sheriff. He thought Ducks would do well in Boston, where visiting friends loved to be taken out on the Charles in his sailboat.

PERMIT HELL. At the time, there were only two other Duck tours in the country: in Branson, Mo.—a waterfront tourist destination, like Boston—and in the scenic Wisconsin Dells, where a returning serviceman launched the original Duck tour right after World War II. Wilson started tracking down collectors of the vintage military vehicles and met Cambridge (Mass.) funeral-home owner Manuel Rogers Jr., who loved the idea and took a \$90,000 stake in the business. That kept Wilson afloat until he could raise \$1.2 million more from 35 limited partners rounded up by a small Boston investment bank. (As general partner, Wilson owns about 25%.) Wilson bought four Ducks, available for as little

though he adds that Wilson's "passionate commitment" to his city, employees, and investors creates a "healthy tension" where to dedicate resources and, frankly, profits.

These days, the Ducks are local icons featured in ads for the Bank of Boston. Yet Wilson is thinking about moving to other things. With nearly 600 tourists a year coming to his door, he can see expanding his "entertainment business"—the business he says he ultimately is in—into profitable new directions involving tours and merchandise for tourists. On the other hand, success has meant more seven-day weeks, and he hasn't taken a vacation in 18 months. "I'm at a crossroads in my life," he says. "You need balance. You've got to have time to watch the clouds roll by."

Although a number of buyers have made offers, he says, they tend to move away when he insists they continue profit distribution and benefits. Now he's considering a sale to his state through an employee stock-ownership program. "I believe in employee ownership," he says. "I'm not anticapitalist, but the human element isn't taken into account enough." By making the most of his human assets, this engagingly odd duck has made his business swim.

By Edith Hill Updike in Boston

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FIND A NICHE —AND START SCRATCHING

Diversity marketing isn't just for the big guys—and may not even cost much

If you thought diversity was simply an employment issue for your business, consider this: According to market research, Hispanics eat more fast food than other groups, and African Americans spend more time on their hair. Older folks consume a lot of luxury travel, while gays and lesbians, proportionately, drink more imported beer.

Starting in the mid-'80s, big companies such as AT&T, Sears Roebuck, and Coca-Cola learned to use market research to target distinct ethnic and demographic niches. They realized that an increasingly diverse community of Americans doesn't necessarily respond to mass-market pitches. But small companies have been slower to jump on the diversity bandwagon, assuming they lack the knowhow and resources to penetrate these markets.

The good news is that diversity marketing is easier than it looks—and not always an expensive proposition. It can be a viable growth strategy—even a survival tactic for your business, says Andrew Erlich, a Woodland Hills (Calif.) multicultural marketing consultant.

Most small businesses still don't target diverse niches, but those that have stumbled into an unmet need like the results. Take Tracey Campbell, who runs InnSeekers (www.innseekers.com), a telephone and online listing service for bed-and-break-

fasts. In June, 1996, Campbell asked members of an Internet discussion group for disabled people what they would prefer to be called in her listings. A contact she made online led to a mention of her service in *New Mobility*, a magazine for disabled people. Calls flooded in. Within ten days of the article's appearance, inns that pay to be included on her service received bookings for over 400 room nights from wheelchair-bound travelers. Turning what she calls

her "flake" discovery into a strategy, Campbell now writes a quarterly column in *Emerging Horizons*, a newsletter for disabled travelers, and caters to the disability over her Web site.

A small business can be well suited to coming out an ethnic demographic niche. David J. Reibstein, professor of marketing at the Wharton School of the University of Pennsylvania, says there's often less direct competition and the customer base may be more geographically concentrated. Still not convinced? Consider some compelling statistics: Among ethnic groups in the U.S., Asians and Pacific Islanders have the highest average household income (\$56,547) as well as the fastest population growth (3.81%) (see page 16). Only 7% of adults have children, meaning they tend to have more disposable income. And if you've counted Americans over 50, note their \$130 billion in spending power.

Diversity marketing can be a relatively simple matter: Take your existing product or service and let a particular group know you're there to serve them. Five years ago, for example, when the Boreal Ski Area—a resort near Lake Tahoe in Truckee, Calif.—with about 30 full-time, year-round employees—wanted to boost business, an ad agency suggested reaching out to San Francisco's large Chinese population. Market research showed that Chinese people value family activities and



STRATEGIES

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New Mobility, a magazine for disabled people. Calls flooded in. Within ten days of the article's appearance, inns that pay to be included on her service received bookings for over 400 room nights from wheelchair-bound travelers. Turning what she calls

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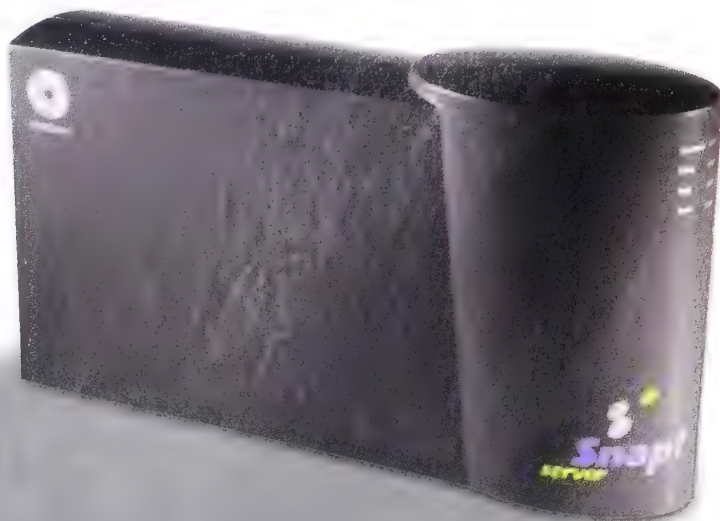
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ON THE CHEAP: Can't afford \$5,000 for an independent marketing report? Do your own focus group. Or just visit an ethnic neighborhood and see what's selling

that Chinese immigrant parents perceive skiing as an activity to help their children assimilate. Since then, the resort has run ads in four local Chinese-language newspapers, advertised on a Chinese TV station, and sent press releases and photos to the Chinese press. "Since we've started the campaign, our Asian customer base has increased by about 10%," says Sheila Greeno, director of marketing at Boreal, now owned by Powdr Corp. in Park City, Utah.

WEB WONDERS. Sometimes, by focusing on niche groups, you can extend your product line. For almost 20 years, Nandini Shah, a general printer in Irvington, N.J., never reached out to fellow Indian immigrants. Then someone asked her to print a traditional, ornate Indian wedding invitation. Word spread, and suddenly she had numerous requests for a catalog. Shah obliged. Now she advertises in *India Abroad*, an international newspaper, and sells her intricate cards from her own Web site. Shah projects the sales of invitations will double from 10% to 20% of her total revenues this year.

Another approach: spin off a whole new business related to your expertise but aimed at one group. Setting up a Web site is one efficient way to do that. For example, Walter Schubert, a gay member of the New York Stock Exchange and owner of a 25-employee investment company, Schubert Group International in Manhattan, took stock of the spending power and computer savvy of the gay community, as well as its concerns about social investing and specialized estate planning. Last April, he launched Gay Financial Network (gfn.com) to market directly to them. GFN has signed up over 3,500 members, who register for free for electronic trading and other services. Schubert was particularly struck by research showing gays and lesbians "are more apt to own a personal computer and stay online longer."

Of course, you can figure out what you think people want—and still run into marketing trouble. Cadaco, a Chicago-based toy and game manufacturer, still sells its eight-year-old "Senior Series" of Tripoley and Poker-Keeno, featuring larger chips, cards, and typefaces to appeal to players aged 65 and up. But the company says sales growth has been stymied by one problem: "Retailers don't have specific shelf space for senior games," says Mark Abramson, director of operations at Cadaco, "so consumers don't even know where to look for our product."

trend-spotting by walking around an ethnic neighborhood. Check out what people are dressed and what's selling in their local stores.

To determine whether a group might be a good target, you might also test the waters by participating in a community event, such as a Caribbean Day Festival. Set up a booth there to gauge interest in your product or service. It suggests Ken Smikle, president of Target Market News, a Chicago-based market research firm specializing in the African American market. Or, if your audience is national, you could exhibit at a specialized trade show, such as New York's annual Gay, Lesbian Business & Consumer Expo.

CULTURE CLASH. Advertising in foreign-language or niche publications can be effective—and economical. A full-page ad in the *Los Angeles Times* runs about \$31,000, but only about \$1,500 in the *World Journal*, L.A.'s leading Chinese-language newspaper. Often, ethnic newspapers will translate your ad for you.

But be aware of cultural nuances when translating your ad or brochure, cautions Wanla Cheng, a principal at

Asia Link Consulting Group, a New York-based marketing research and consulting firm. For instance, she says, Vietnamese, as recent immigrants, respond better to an ad depicting nostalgia for one's homeland than do longer-established Chinese. Beware of offensive color choices. White symbolizes death to the Chinese, while red for South Koreans, is linked to Communism, says Saul Gitlin, director of strategic marketing services at Kane Lee Advertising in New York City, which specializes in the Asian-American market.

To be sure, looking at the world through rainbow-colored glasses takes practice. But give it a try. You just might be surprised at what comes in focus.

By Barbara Hetzer in New York

A RAINBOW OF POSSIBILITIES

Often, diverse market segments lead to a pot of gold

TARGET GROUP	1998 POPULATION MILLIONS	EXPECTED ANNUAL GROWTH BY 2001	CURRENT PURCHASING POWER BILLIONS
HISPANIC	30.2	2.09%	\$300.0
ASIANS AND PACIFIC ISLANDERS	10.3	3.81	150.0
AFRICAN AMERICAN	34.3	1.45	450.0
DISABLED/HANDICAPPED	54.0	NA	175.0

DATA: U.S. CENSUS BUREAU, CHISHOLM-MINGO GROUP

How do you decide if diversity marketing makes sense for you? If your business is primarily local, think about the predominant groups in your area. Is there a large elderly population or a big Hispanic community? A good starting place for gathering such market information is your own customer database. See who's buying what and where they live.

For professional help, you could hire an ad agency or market research firm specializing in diversity issues. (A marketing report costs about \$5,000.) But if you can't afford it, you might do your own legwork. Assemble your own focus group by inviting in members of the target community. You might offer some incentive, such as refreshments, free product samples, or discount coupons. Or, do a little of your own

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In the pages that follow, you'll read about how small businesses like yours can take advantage of computing technology to become more efficient, competitive and profitable. You'll find specific resources for advice, products and solutions. And you'll discover that you can start reaping benefits from computing technology now, regardless of how much or how little you already know about computers.

Your business might be small, but your business challenges aren't. ►

Fewer employees doesn't translate into fewer hurdles. But it does mean each person has to wear many hats. Small businesses need creative ways to keep pace with competitors large and small, without burning their people out. This is why computing technology is so compelling.

What is computing technology anyway? In its broadest sense, it means using personal computers (PCs), servers, networks and the Internet to help you make money, save money, and save time. By doing business electronically, you can lower your operating costs, do

more with existing people and resources, expand your customer base, improve customer service, and develop smoother working relationships with your suppliers. In other words, technology can help you do the things you do today better, more easily, and more efficiently.

Computing technology is a tool, not an end in itself. It augments your company's unique skills, quality and creativity, helping you deliver your products and services more widely, more cost-effectively and with greater impact. You can join the technology bandwagon at any point—and joining in is easier and more affordable than ever before.



► **Robert Levy, CRS, of Portland, Ore., a top-selling realtor with Prudential Northwest Properties, represents an average of \$10 million annually in property value. He recently plugged into the time-sensitive needs of his busy, computer-savvy prospects with networked Intel® Pentium® II processor-based PCs and an innovative Web site (www.roblevy.com).**

Levy can directly attribute \$57,000 in net income in six months from Web inquiries and

e-mail. He has office and home desktop PCs for himself and his one assistant, plus a notebook PC for making presentations and running house searches with customers on the spot. All the systems are networked for easy information transfer from one to another.

"I do the same volume of business as some other agents

who have three to five assistants—and I have one," says Levy. He heavily promotes his Web site on all his ads and flyers and uses the speed of technology as a selling point. "Computing technology lets me be on top of the market—instead of the market being on top of me," Levy says. "Some realtors may sell more houses than I do, but doing it this way affords me a life. Computing technology lets me keep balanced."

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Or visit us on the Web. [▶ www.intel.com/business/small](http://www.intel.com/business/small)

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PC World Top 5 Power Notebooks

Vendors	Aug '98 Ranking	July '98 Ranking	June '98 Ranking
Quantex H1331*	1*	1*	1*
Dell 3200 D266XT	2	2	2
Dell CPi D266XT	3	3	n/a
Micron GoBook 266	4	n/a	n/a
Gateway Solo 5100 LS	5	5	n/a

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For employees who telecommute, work at a customer or job site, or travel on business, mobile or laptop PCs are a good choice. With a high-performance laptop PC, you can access your business-critical documents and databases anytime from

anywhere, ensuring that you never miss an important deadline or decision. And today's laptop PCs are smaller, lighter, faster and more affordable than ever before, making them an important consideration for any small business.

Get connected—within your company and to the outside world. ► An estimated 75% of small businesses currently have no network in place, yet studies show that nearly all plan to get networked. Networking, or sharing computing resources among multiple PC users, is critical. It is the key technology
(Continued)

**At each stage of technology adoption,
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no matter what business you are in.**

► High-performance PCs based on the Intel® Pentium® II processor are the ideal basis for any kind of technology solution you decide to pursue. The Pentium II processor delivers high performance on everything from office productivity appli-

cations to sophisticated design and publishing packages. Wearing multiple hats means processing multiple tasks at the same time, and Pentium II processor-based systems make a multitasking computing environment more efficient than ever.



The headroom provided by Pentium II processors means that your PC will continue to be a productive investment longer. And now laptop PCs with the power and capabilities of the Pentium II processor are also available. Intel also offers the Celeron™ processor capable of running today's most common PC applications. The Intel® Celeron processor provides the dependability you expect from Intel at an exceptional value.

Quantex *High-performance mobile PCs let you take your business with you on the road: give colorful presentations, access e-mail and the Internet remotely, and work on powerful business applications in the office, at home or while traveling. The Quantex* H-1331 "desktop alternative" notebook combines the performance of a desktop PC with the advantages of mobility. It's like getting both a desktop and mobile PC for a single investment.*

With the Pentium® II processor, real servers and powerful networks are now within reach for your small business. Pentium II processor-based servers provide scalable performance, built-in manageability and affordability to support your business-critical functions—e-mail, customer/inventory databases, your Web site—and help your employees share data and better serve your customers with real-time information.

The Intel® InBusiness™ networking products are simple and affordable network solutions designed for 2 to 50 users. The Intel InBusiness Internet Station, LAN adapters, and fast hubs get you connected internally and to the Internet, so you can do business directly with your bank, office products company, parts suppliers—essentially everyone on the Internet.

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for staying in touch with all the people that matter to your business—employees, customers, suppliers and business partners. The question is not whether to network, but what kind of network best supports your business model

Imagine the productivity gains from keeping your financial records, customer lists, parts catalogs and price lists updated and easily accessible to everyone at your company—to improve communication among your employees and respond more efficiently to customer requests

You can start by connecting your PCs internally with “peer-to-peer” network. This basic network links your company’s PCs with each other and with various computer devices. When your employees share

files, printers, modems and other equipment, productivity climbs, costs diminish, and you maximize your investment in existing software and hardware.



Acer *With fewer people and resources than large businesses, small businesses have to work harder for their money. Acer offers a line of desktop and notebook PCs and servers designed specifically for the challenges that small businesses face. Acer products feature high-performance Intel® Pentium® II processors, integrated networking and audio/video capabilities. Plus their built-in software solutions and licenses can help you leverage computing technology to work better, smarter and faster.*

If multiple people in your company need access to real-time information or your business depends on key software running 24 hours a day, you might consider a "client/server" network, where one or more servers distribute or "serve" information to the "client" PCs on a network. By centralizing shared resources on a dedicated server, data can be better maintained and controlled.

Expand communication with the online world

Networking technology also helps you build your business through closer collaboration with your external suppliers and partners, and makes it easier for them to do business with you. Begin connecting to the external world by opening an e-mail account and obtaining access to the Web with an Internet Service Provider (ISP). E-mail lets you quickly and cost-effectively respond to

inquiries, send documents electronically, and save time and money on photocopying, shipping, faxing and telephone calls.

To go one step further, you can let the world know about your company through your own Web site. Web sites are easy to set up with today's advanced software tools and can reside on your own server or on a server located at your ISP. Because the Internet is available 24 hours a day, seven days a week, customers and suppliers can learn about your products and services at their convenience.

You might also set up a private web site, or intranet, for your employees. Intranets provide exclusive access to company information in one central location, allowing your employees to easily communicate,

distribute information, and collaborate on projects across your company. Expand your intranet to include suppliers and customers and you have extranets.



Personify Inc.
(www.personify.com),

a small business of fewer than 20 people, sells interactive marketing software and services that enable businesses of all sizes to "personify" their Web site audiences: to analyze and anticipate customer preferences and convert site visitors into loyal customers. Personify merges the proven essentials of traditional marketing with the immediacy of the Web environment.

"Our browser-based, point-and-click Web marketing

software statistically models visitors' behavior, identifies key market segments, and enables real-time predictive targeting of promotions, content and e-commerce transactions," says Eileen Gittins, Personify's CEO. "We help companies answer strategic, not simply logistical, questions about e-commerce. For small businesses, we help level the playing field with tools that make them look bigger than they are." Personify deploys Intel® Pentium® II

processor-based technology on all its desktop, mobile, and server systems, and it has designed its software for the Intel architecture. "We intentionally focused on Intel® processor-based systems for the combination of low cost and high performance," says Gittins. "With the affordable horsepower of the Pentium II processor, we can offer the rich application features and real-time responsiveness that fast-moving businesses require."



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Intranets are used to create electronic communities in which buyers and sellers collaborate online, thereby streamlining business processes (such as inventory management), saving everyone time and money.

In summary, the benefits of getting connected within and outside your company are enormous. Making everyone in your supply chain more productive helps you deliver products and services faster and lowers your operating costs. You can take the time you would have spent pushing paper or playing telephone tag and use it to expand your business.

Business software helps you with all the key tasks required to run your business every day: create documents, manage your finances, schedule appointments, analyze customer data, and market your business. Many of the most popular small business software applications run faster on systems powered by the Pentium® II processor.

The Intel® Showcase on the Intel Web site (www.intel.com) highlights software and Web site content that benefit from the performance of the Pentium II processor. You can find applications in a number of business categories, such as office productivity, accounting and finance, sales and marketing, communications and Web page development.



showcase
Try it on a **Pentium II**
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Do business on the Web. ► Your small business can use Internet technology to reach even further into the online world and improve all aspects of your business, from customer service to sales. Electronic commerce (or e-commerce), means selling and/or buying goods and services over the Internet. Your Web site, in addition to providing critical information and support, can help you grow sales by giving new and existing customers the option to buy your products and services directly online, around the clock.

Supporting the intense processing demands of e-commerce with real-time transactions conducted online requires a server running specialized software. If you decide to host your own Web site and process transactions yourself, it is a good idea to invest in a dedicated Web/transaction server. Alternatively, you can establish an account with an ISP capable of processing your e-commerce transactions on its servers.

► HotOffice *When your work happens beyond 9 to 5, and away from the office, it's crucial that everyone be able to access company information and communicate effectively, anytime and anywhere. Using the latest Internet technologies, the HotOffice® Web-based networking solution acts as a central communications point, helping your employees share and revise documents, find crucial information and records quickly, communicate electronically across time and space, respond instantly to customer requests, and turn ideas into action.*

By expanding your abilities to do business electronically, you will be in a position to strengthen

relationships with your suppliers. Many suppliers have invested in computing technology and are making it available to you, further supplementing your own capabilities without enormous investments at your end.

For example, maybe you like the idea of creating brochures, product data sheets or dazzling presentation slides in-house, but you won't do these activities often enough to justify buying the necessary specialized equipment. Kinko's offers a full range of high-technology services especially designed for small businesses—everything from high-speed digital color copying and custom printing to video conferencing and sending documents electronically to Kinko's via e-mail.** Take advantage of Kinko's investments in leading-edge



 **Microsoft** *Small businesses today are looking for ways to better manage and communicate with customers, get the information needed to make better business decisions, and be as efficient as possible. Microsoft BackOffice* Small Business Server provides e-mail, Internet access, and fax and modem sharing—so it's easy to communicate with customers and suppliers. And your business is able to be more efficient with your resources because you can easily share printers, files and applications within your company.*

digital technology and expertise until you can justify your own purchases, or as a permanent solution to your periodic high-end requirements.

Similarly, you could probably appreciate less time wasted standing in bank lines, waiting on hold on the phone, or converting bank statements into a format compatible with your accounting system. Citibank offers Business Access, an online computer banking service for managing finances and banking transactions conveniently from any PC. Citibank's Business Access delivers timely and secure information on all your bank accounts, 24x7; handles routine banking transactions; and downloads account information to your spreadsheet software, organized the way you run your business.



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Where do I go to get what I need?

Now that you're armed with information on what computing technology can do for your small business, what's next? The first step is to examine which of your current and future business goals you can meet with technology. Be realistic about how much computing technology you want to acquire and install on your own, especially if you don't have a computer specialist on staff. Once you've defined your goals, consider finding a technology consultant who can help you refine your requirements and implement a technology solution tailored to your business needs.

KEY ATTRIBUTES TO CONSIDER WHEN SELECTING A COMPUTER CONSULTANT INCLUDE:

**Hardware expertise
Software expertise
Commitment to service
Technology planning
Small business focus
Experience/time in business
Cost consciousness
References**

A good technology consultant should help you answer specific questions, such as:

- ▶ What type of solution will meet my current business needs as well as grow easily and cost-effectively to meet future needs?
- ▶ Do you provide everything (software, networking products, servers, customization, etc.) I'll need?
- ▶ What aspects of the system can I or must I put together and manage myself?
- ▶ What types of service and support do you offer (call-in, 24x7, etc.), and how do you charge for support?
- ▶ Do you have references from other small businesses with needs similar to mine?

For further advice on how to choose and implement technology solutions, Intel will launch its new Intel Authorized Solution Provider (IASP) program in the latter half of 1998. This program supports premier Intel resellers committed to providing technical expertise and solutions to their customers. As an IASP, a reseller must complete intensive training and testing designed to give them the knowledge, tools and skills needed to help your small business. To find the IASP nearest you, call 1-800-538-3373.

▶ www.intel.com/business/small

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THE COOKIE LADY OF SILICON VALLEY

British baby nanny catches the startup spirit

Jean M. McGraw is a 60-year-old grandmother of four, looks like a thin Mrs. Doubtfire, and has made her living for the past 13 years as baby nurse to some of the richest, most famous families in San Francisco and Silicon Valley. Time, one would think, to settle surely into her golden years. But McGraw, a Nike-sold Englishwoman, running as fast as any entrepreneur in the Valley. The difference: Her sleep deprivation stems from making cookies, not writing software. And the 800-pound rilla she faces isn't Microsoft Corp.; it's baker in Scotland. Her two-year-old business, McGraw's Shortbread, launched with \$10,000 in personal savings, has been nibbling its way into such fancy shops as Dean & DeLuca, Wegmans Markets, and Neiman Marcus, which charge \$18 to \$4 for a one-pound tin. "We clicked because she's not pushy—she's bubbly and English, and she has a good product," says Richard W. Rachfal, a buyer for Wegmans.

LINKING BIG. McGraw recently signed a deal with British-owned W. H. Smith Co. to sell cookies in 10 of their California hotel shops; she's also selling online Web and in catalogs. McGraw is projecting sales of \$150,000 this year, up from last year's \$30,500. But for a thumb-size business, she's thinking big. Eventually, she hopes to take a bite out of giant Walkers Shortbread Ltd. Her secret weapon: her grandmother's recipe, which yields a buttery bis-

cuit with a light, crumbly texture. (She has also added such flavors as chocolate chip, lemon, and English toffee.)

How did McGraw move from baby nurse to successful entrepreneur? "I'm self-motivated and self-taught," she says. After completing high school at 15, in

nology publisher and broadcaster. "Somewhere else, she might not have received encouragement, but there is no more entrepreneurial culture than the Bay Area."

Indeed, for years, says McGraw's son and partner, Barry R. Nash, 36, "people would tell me and Mum that we should start a business." But they pooh-poohed the suggestions until October, 1996, when McGraw's friend, Greg G. Eisenman, a regional manager for The Honeybaked Ham Co., gave her a 400-tin Christmas order. McGraw took the plunge, renting a kitchen by the hour. Her relatives, still living in an English village, thought she was crackers starting a business at her age—until she sent them her shortbread in a stylish gold tin.



GRANDMA'S RECIPE: McGraw and her son and partner, Barry Nash, not only bake but design packaging, make sales calls, and market their shortbread

PICK BRAINS. Soon, McGraw was attending seminars offered by the Service Corps of Retired Executives (SCORE) and picking the brains of former clients, such as Nancy J. Pedot, former CEO of Gymboree Corp. "She'll call me and bounce ideas around, but she knows where she wants the business to go."

Besides baking, McGraw and her son design the packaging and make the sales calls. And they still rent a kitchen by the hour. But now, McGraw is seeking a \$50,000 Small Business Administration loan to expand and lease a

bakery-and-warehouse space.

As if that weren't enough, half the week, McGraw goes from patting dough by day to patting babies' bottoms by night. "It is difficult to find the time to do everything," she concedes.

Like the tech startups of Silicon Valley, McGraw and Nash have plowed all their dough back into the business; in four or five years, they hope to sell out to a larger company. "But what would I do then? Probably start another business. It's exciting. Silicon Valley has rubbed off on me," laughs McGraw. Her chips may be chocolate, but the Valley spirit has clearly baked in.

By Gary Andrew Poole in San Mateo

ENTREPRENEURS

England, she worked for Philips Electronics as a data processor; took care of her sick mother, married, and raised three children in Britain. In 1980, she visited the U.S., fell in love with the San Francisco Bay area, and moved there permanently in 1983. McGraw first worked as a nanny and later developed a specialty in newborn care. One referral led to another.

Besides tending babies, she baked cookies for her clients—many of whom are now her biggest boosters. "I'm a sucker for entrepreneurial activity, and her cookies are awesome," says Halsey M. Minor, CEO of CNET, the Web tech-

THE MANY VIRTUES OF 'VIRTUAL SERVICES'

Just log on to the Web, and check out the panoply of providers

The young founders of Manhattan's StockObjects don't need a pep talk on the power of the Internet. That's where they make their living, marketing a Web-based library of animated pictures, 3-D models, and other multimedia elements for companies' Web sites. And when they need to custom-produce projects for their library, they hire programmers from around the world—again, over the Internet. So when StockObjects wanted some Net-savvy financial help, Chairman and President Mark Tribe turned to a Net-focused accounting firm for help: Virtual Growth Inc.

The firm, also in Manhattan, offers clients such as StockObjects the services of a chief financial officer, controller, and accountant over the Net. For example, as part of the "Virtual CFO" service, StockObjects Chief Operating Officer Jeff Phillips plugs quarterly financial data into an Excel software template set up

OUTSOURCING

by Virtual Growth, and the program generates a balance sheet and cash-flow projections. Phillips E-mails those spreadsheets to the firm, where an assigned CPA interprets the data and advises the company on strategy. Besides acting as CFO, Virtual Growth does traditional accounting work, files tax forms, takes care of payroll, and pays the bills. The total cost: \$1,700 a month. Granted, it's not quite the same as having a full-time financial staff. Business communications are handled mostly by E-mail and telephone, along with periodic face-to-face meetings. But hiring a full-time CFO could cost \$100,000 or more. StockObjects President Tribe says the arrangement works well for now. "They're not a substitute for a CFO—they're allowing us to go longer without one."

"GOT TO BE CHEAPER." It's the latest twist on outsourcing: Small businesses are starting to get help from virtual services camped out on the cyber-frontier. Do a little surfing and you'll find "virtual assistants" who word-process, plan events, and handle other office chores over the Net; online consultants who dis-

pense advice by E-mail; a computerized transcription service; and human-resource management companies that let you tap into expensive software for managing employee benefits. These virtual service providers will probably never shake your hand. The bulk of their work will be

HANDS ONLINE: Word processing, consulting, event planning—it's all available on the Net

done by E-mail, electronic file transfer, password-protected Web sites, and Web-based software.

While the move to "virtual services" is in its infancy, small-business consultants say these services are worth considering. Outsourcing, in general, can cost 5%

less than hiring a full-time employee, according to Hackett Group's Hudson (Ohio) consultancy. And Bill Ebeling, partner at Boston's Braxton Strategy practice of Deloitte & Touche Consulting Group, predicts that more services will be migrating to the Web soon—particularly

those that rely on databases—because of its greater speed, convenience, and lower cost. "If you can program something, and it fits 75% of business situations, it's got to be cheaper than a human being," says Ebeling.

Such thinking propelled Stephen King to start Virtual Growth in December 1995, figuring he could focus on financial strategies for his clients who were letting software

handle the donkey work. "Clients don't

want to pay for bank reconciliations and sales-tax calculations, they want to pay for consulting advice," says King, whose 17-person firm serves about 50 small businesses, most of them new-media startups in New York, Boston, and Phoenix.

Another new service that hopes to capitalize on savings from technology is Fast Church (Va.)-based Vco LLC, which was launched in mid-August. The firm has created a database of fe-





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eral Occupational Safety & Health Administration regulations that will let clients design their own compliance program rather than pay a consultant. At V.com's Web site, you fill out a questionnaire, and the database spits back both a compliance checklist, tailored to your business profile, and a schedule to follow to stay within the law. Fees are expected to range from \$550 to \$1,000 a year, depending on the number of users at a company.

While the system won't alert you automatically when regulatory changes take place, V.com's attorneys will update the database frequently, and clients can check in to get updates on changes. "We could do this thing by hand, but we'd have to charge about

Meanwhile, Branch Office, owned by Amy Sarai in Bridgewater, N.J., and her sister Julie Hewett in Huntington, W. Va., works with about 30 clients, some as far away as Japan. Client Robert Horowitz, a Stamford (Conn.) investment adviser, uses Sarai to supplement his part-time office help. "Amy is doing things for me that someone who's not in the virtual world can't do, like searching the Web and managing E-mail," he says.

Another new service hardly depends on human contact at all, thanks to voice-recognition technology. Cyber-Transcriber lets clients such as Tom Thees, owner of the Pinnacle, a 120-employee company that owns three meeting and banquet facilities in Toledo, dictate letters and memos from his

tion, and a company can analyze data to see how it is utilizing benefits. At \$10 to \$4 per employee per month, plus setup fees, it's cheaper than buying your own software system, which can run upwards of \$100,000. And you don't have to install, maintain, or upgrade it.

HOMEWORK. In some cases, traditional outsourceurs are starting to offer a new Internet option as a convenience. Reoland (N.J.)-based Automatic Data Processing Inc., a big-payroll processor, plans to bring its service online in the coming months. Clients will be able to log on to ADP's Web site and enter all the relevant information on employees' hours right into ADP's payroll database. Now, the majority of ADP's 40,000 customers call in their payroll information.

Virtual Outsourcing

Cyberspace services are just coming online.

Here's a sampling of Net-based resources that might help manage your business.

NAME	PHONE/URL (www.)	SERVICE	FEES
CYBERTRANSCRIBER by Speech Machines	(650) 568-1500 cybertranscriber.com	Phone-in dictation/transcription	\$29.95 registration fee plus \$9.75 per month; \$3.50 per page
EMPLOYEEASE	(888) EASE NET employeease.com	Internet-based system for human-resources management	Setup fees of \$250, plus \$5 per employee; \$1-\$4 per employee monthly
GLOBAL ASSOCIATION OF VIRTUAL ASSISTANTS (GAVA)	(908) 231-0994 gava.org	Trade group maintains directory of Net-based administrative assistants	None for referral. Assistants charge \$20 an hour and up
VIRTUAL GROWTH INC.	(212) 532-8060 virtualgrowth.com	Functions as accountant, controller, and CFO	Depends on volume. Current clients pay \$1,000 to \$4,000 a month
V.COM	(703) 533-5550 v-osh.com	Creates customized compliance plans to meet federal OSHA regulations	\$1,000 or less per year, depending on number of users in a company

DATA EN

10 to 20 times what we're charging," says Managing Partner David C. Frankil.

"TO DO" LISTS. Need some secretarial or administrative help? Thanks to the Internet, virtual assistants, who often work from their homes for customers they never meet, might make your business run more smoothly. For fees ranging from \$15 an hour and up for word processing to \$50 an hour for more sophisticated services, such as event planning or publicity, virtual assistants handle business by E-mail, file transfers, and Web sites. For example, at the Web site of virtual assistant Chris Durst, owner of My Staff in Woodstock, Conn., clients can check virtual calendars, where Durst has scheduled their appointments, or get reminders on their "to do" list, which she keeps current.

cellular telephone anywhere, anytime. Operated by Speech Machines of Menlo Park, Calif., the service's computers translate speech into text at 120 words per minute. After proofreaders check for misspellings, the text is E-mailed back to the client. In addition to a monthly subscription fee (table), Thees pays about \$3.50 a page—the same as a local transcription service—but gets it back much faster.

Smaller companies are just starting to go online for access to the type of sophisticated human-resources software big companies use. Employeease Inc. in Atlanta is marketing a new service for small and medium-size companies that manages benefits information on its computers. Company employees can log on to a password-protected Web site to change or update benefits informa-

If you're interested in finding virtual services, be prepared for a little homework. Try using an Internet search engine to browse under specific topics, such as accounting, or inquire about virtual services with the relevant trade groups. Checking references becomes particularly important when you can't meet your virtual provider in the flesh and have only their Web site to go by. And, as with any outsourcing, there's no free ride. "Remember," warns Heather Ashton, an analyst with Hurwitz Group, a Framingham (Mass.) consulting firm, "the function still requires management. Or, should we say, virtual management."

By Anne Zieger in Reston, Va.

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APT PUPIL: Norman I. Bruckner, a Dallas chemist, is a student at the Bill J. Priest Institute for Economic Development, part of the Dallas County Community College District.

BACK TO SCHOOL, WITH A DIFFERENCE

A community college can be a small business' best friend

Dallas chemist Norman I. Bruckner, 52, started his business, Bruckner Chemicals, in 1988. He spent the first year of his business learning the ropes of the industry. He became a consultant last year after taking early retirement. He realized there was a lot he didn't know—how to write a business plan, for instance, or how to patent the products he hoped to develop and market for clients. He sure didn't know how to write a business plan in biochemistry, though. What he needed was nuts-and-bolts information. So he turned to an institution long on practicality if short on snob appeal: his local community college.

At the Bill J. Priest Institute for Economic Development, part of the Dallas County Community College District, Bruckner took five seminars over six

months that ranged from basic business-plan writing to patent law—spending a grand total of about \$100. But that's not all. At the college's North Texas Small Business Development Center, Bruckner learned that local patent attorneys had developed new software that could walk him through the patent application process. The lawyers charged Bruckner \$280 for the software, then gave free follow-up counsel that helped him file his first patent application for a medical device. Next time, he will be able to go solo. His total outlay, including the \$500 application fee: about \$880—compared with the \$7,000 he figures he would have spent on legal fees.

As Bruckner's experience shows, the help your business needs may be closer than you think. Community colleges can

least expect it. Often overlooked as two-year schools, community colleges offer a treasure trove of free or low-cost resources. The reason? These colleges play key roles in many regional economic development efforts, and their public mission usually is supported by some combination of local, state, and federal funding.

Need help retraining employees handling succession issues? Want to bone up on accounting or learn about import-export regulations? Depending on where you live, you're likely to find a range of services—classes and seminars, support groups, and professional counseling—tailored to local needs. For example, Lehigh Carbon Community College in Schuylkill, Pa.,

COMMUNITY COLLEGES

has set up a family business center to help the many family-owned companies in the region. Among its services are support groups for family business owners and classes on business valuation, conflict resolution, family dynamics, and succession planning. "Only 12% of [family] companies make it to the third generation because of succession issues," notes Ann D. Biel, director of continuing education.

While community college programs



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Education

vary from state to state, more than 90% of the nation's 1,123 community colleges have formed partnerships of some sort with industry or business groups, according to the American Association of Community Colleges. And many, including Dallas Community College, serve as local offices of the federally funded Small Business Development Centers, created to foment entrepreneurship and reduce the rate of small-business failures. Last year, for example, the North Texas Small Business Development Center, of which the Dallas colleges are part, provided nearly 27,000 hours of free consulting to about 6,500 clients.

The consultants who work at community college programs are often part-timers or volunteers with small-business experience who can relate to your problems. What's the quality of their advice, teaching, and training? "Mostly, it's not rocket science that's involved," says David B. Thornburgh, who worked closely with community colleges while heading up the small-business development center at Wharton School of Business. "If you're Michael Dell at 19, maybe you're better off at Wharton. For 98% of small businesses, what the community colleges offer is efficient and practical."

LIFELINE. Some community college programs help you apply for state grants to build your business with the broader aim of boosting local employment. Kathy Bennett, vice-president of Bennett Packaging in Kansas City, Mo., a cardboard box manufacturer, initially contacted nearby Metropolitan Community Colleges' Business & Technology Center for help finding workers. The college did give her a list of names—and then directed her to one of its staff counselors, Eugene P. Fisher. He helped her win a \$78,834 state grant from a fund specifically earmarked to bolster manufacturing businesses—and thereby increase job opportunities—in the state. Bennett matched that grant, which the college administered. In part, it paid for full-time consulting help to stream-

line production systems. The company just received its second, yearlong grant and is about to add another full-time counselor.

Bennett says that without Fisher's involvement, she never would have heard about the state grant program. Thanks to the streamlining efforts, she says, productivity has improved 20%, and unscheduled machine downtime has decreased 35% in the past year.

Community colleges can be a lifeline for small companies at various stages of their development. Susan M. Crinnian, a 46-year-old computer consultant in Phoenix, learned how to write a business plan at Pima Community College in Tucson, Ariz., before launching her com-

turing and health-care companies and helps them set up E-mail security systems. Thanks to the free advice, she's bringing in about three new clients a month, up from just one a month, or less, two years ago. She predicts her revenues will rise from \$1 million in 1997 to \$1.5 million this year.

Community colleges also can help with retraining, a key concern in today's tight labor market. Programs often address specific local industry problems. Quinnebaug Community-Technical College in Danielson, Conn., for example, worked with local plastics manufacturers to create courses any single company would have found too expensive. In California, San Diego City College (a community college) retrained laid-off defense industry workers and helped companies convert their factories and technology to nondefense uses.

TEST DRIVE. Sinclair Community College in Dayton, Ohio, teamed up with the University of Dayton to form the Advanced Integrated Manufacturing Center. There, employees and management participating companies in the local tool-and-die industry have taken two week-long training courses tailored to each company's needs. "The thing I really liked was that they treated me like a customer," says David W. Dysinger, chairman and chief executive of Dysinger Inc., a 92-employee precision toolmaker in Dayton. The center also lets area businesses test-drive state-of-the-art manufacturing technology before making major investments.

Unfortunately, there's no central clearinghouse for colleges and programs that can help small business. You'll need to scout around a little to find the most convenient and suitable. Check with your local community college for a Web site. You can also check with one of the college trade associations (table) or call your local Chamber of Commerce. You won't find an Ivory Tower at your local community college, though for sure. But you just might find the help you need.

By Susan Jackson in New Haven

Hidden Treasures

Where to dig up information on community college programs

NAME PHONE/WEB ADDRESS	COMMENTS
AMERICAN ASSOCIATION OF COMMUNITY COLLEGES 202 728-0200 www.aacc.nche.edu	Represents all 1,123 of the institutions, and may be able to help you find the right contacts at a nearby school.
MANUFACTURING EXTENSION PARTNERSHIP 800 MEP-4MFG www.mep.nist.gov	Has more than 400 centers and field offices, two-thirds of them connected with community colleges. MEP provides technology assistance, training, and consulting for existing small businesses.
NATIONAL COALITION OF ADVANCED TECHNOLOGY CENTERS 800 231-3015 www.cord.org/ncatc.htm	Has programs on 70 college campuses, including community colleges. In addition to providing training, NCATC helps small companies benchmark against peer companies.
ASSOCIATION OF SMALL BUSINESS DEVELOPMENT CENTERS 703 271-8700 www.sbaonline.sba.gov/SBDC	The membership group for federally funded SBDCs, has almost 1,000 service locations, many at community colleges. They provide subsidized counseling and other services.

pany, CCI Networks, Inc., which helped clients set up internal E-mail systems.

After she moved her business from Tucson to Phoenix, she once again needed advice: Her clients had started switching to Internet-based E-mail. "Suddenly, my business plan didn't fit," says Crinnian. This time, she turned to Maricopa Community Colleges' Small Business Development Center in Phoenix for help refocusing her five-person company. At no charge, Crinnian met weekly for six months with her counselor, who helped her revamp her business plan and taught her how to bargain with distributors and software manufacturers. Now, Crinnian sells and installs intranet software for manufac-

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		OHIO	
		Cleveland	
		TENNESSEE	
		SOUTH CAROLINA	
		St. Petersburg	
		WASHINGTON	
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PICKING A PHONE PLAN FOR SAVINGS

New fees make it a good time to shop around again

Compare a recent long-distance phone bill with one of last year's, and you may discover the cost has gone up as much as 15%. But don't blame your staff for making longer calls. The culprits are actually two separate fees that took effect at the beginning of this year—and the uneven way they're being applied by phone companies. It's just one more reason to take a fresh look at your long-distance plan to see if it's the best deal you can get.

The fee that has made the most difference is the Universal Service Fund fee, essentially a tax to subsidize telecom services for schools, libraries, and rural communities. Long-distance carriers have to kick into the fund 3.9% of their billings on interstate calls. But

that's on the company's total interstate billings. And some carriers have chosen not to impose the fee equally on all customers. Qwest Communications, for instance, isn't billing residential customers. It makes up the difference by charging business customers 4.9%. Is that fair? "It doesn't help small-business customers," concedes spokesman Tyler Gronbach, "but we are currently looking at alternatives to work this out."

The second fee—the "carrier line

charge" on the phone bill—was supposed to reduce the per-minute cost of long-distance calls by rejiggering the way long-distance carriers pay local phone companies to use their lines. While the new charge has been passed along in your bill, the savings probably haven't. There's really no way to tell on an individual account. But filings with the Federal Communications Commission show that long-distance carriers on average are paying a penny less each minute—yet no major carrier has announced wholesale rate reductions for existing customers.

Since these fees are new, billing mistakes can crop up. Just ask Diane Vaclavik, vice-president for marketing at St. Louis Data Destruction, a Maryland Heights (Mo.) shredding service. She discovered she was being overbilled \$13.75 a month in carrier-line charges on five lines after inquiring about the unfamiliar fees that were appearing on her bill. "I spent more than \$13.75 of my time to get it done," Vaclavik says of her quest for a refund. "But I had to—or else get billed this much every month."

CHECKLIST. To ensure you aren't being overcharged, there are a few parts of your bill you should check. First, take a look at your USF fee and divide the sum by the total interstate calling charges before taxes. If it comes to more than 5%, ask the carrier exactly how it's calculated. Second, take the number of phone lines and multiply it by your phone company's carrier-line fee (typically \$2.75) to get your carrier-line charge. Finally, divide the long-distance charges by the number of calling minutes to double-check your per-minute rate vs. the rate you obtained when signing up. If you find errors, insist on a refund for the overcharges.

Even if you don't find any errors, changes in rates and fees make it a good time to take a hard look at your bill and shop for a competitive plan. If you find a better one, be prepared to jump ship. Carriers are quick to offer lower per-minute rates for new accounts and reluctant to do so for existing customers, though if you're armed with a better alternative, you might cut a better deal. Remember, USF and carrier-line charges

BILL SHOCK: Carrier-line charges can add as much as 15% to your monthly total

Sneak Preview

"Roadway helps stage Hollywood opening hit!"



Dave and Buster's had a problem. In the process of opening their newest store, a mishap with a vendor resulted in **two shipments** being placed on the same truck. But one of those shipments was **needed overnight** in Hollywood,



Florida for a Sneak Preview Party at their newest store.

Roadway Customer Service Representative Diane Martin came through with **a star performance.** As

D&B Corporate Warehouse Manager Kevin Molden

puts it, "Diane was able to locate the shipment, intercept the order and get it to the store

12 hours ahead of their Sneak Preview

Party. Without her knowledge, concern and follow-through, our new store would have gotten off to a less than favorable start."

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Buyer's Guide

won't be quoted in the overall rate.

To make it easier for you, we've analyzed the long-distance service programs—including new fees—at the seven biggest providers in 1997: AT&T, MCI, Sprint, WorldCom, Excel, Frontier, and Qwest LCI. We included only small-business plans that don't require you to sign up for a minimum period. Although plans with set time periods do feature better prices, the FCC is expected to adjust the fee structure in 1999, and we prefer the flexibility of being able to switch providers as needed.

We then evaluated the plans based on three calling scenarios reflecting light to moderate usage; high-volume usage wasn't analyzed because often companies with big bills can negotiate better rates than those listed by the carriers. To make the comparisons fair, we included the USF and carrier-line charges in addition to the basic long-distance rate. And in all cases, we assumed all long-distance calling was interstate and confined to the continental U.S.

It wasn't easy because long-distance rate plans have a lot of moving parts even without the two new fees. For starters, you have to consider the initial call length. For instance, AT&T, MCI, and Qwest will bill you for a minimum half-minute call even if you hang up after the first five seconds—while other companies will bill you for only 18 seconds. After that, most carriers bill in increments of six seconds, rounding upward even if you hang up after one second.

SMALL CHANGE. So which phone plan is best for you? Say you don't make many long-distance calls since your customers are local, but you do have multiple phone lines. In this case, Qwest LCI's Q.biz plan stands out. Assuming you have five phone lines and make about 500 minutes of calls, you'll pay about \$77 a month. (MCI is a close second, with the same final bill but slightly less-generous billing increments of six seconds vs. Qwest's one-second rounding.) Frontier Corp.'s EZ Plan actually worked out to be \$2 less, but it comes

		TOTAL MONTHLY COST			
COMPANY	PROGRAM	UNIVERSAL SERVICE FUND FEE	"500 MINUTES, 5 LINES"	"2,500 MINUTES, 8 LINES"	"5,000 MINUTES, 10 LINES"
AT&T	ONE RATE FOR BUSINESS	4.1%	\$82	\$366	\$717
EXCEL COMMUNICATIONS	PRIME BUSINESS SELECT 3	3.9%	\$118	\$334	\$625
FRONTIER CORP.	EZ PLAN	4.9%	\$75	\$330	\$644
MCI	ONE FOR SMALL BUSINESS	5.0%*	\$77	\$337	\$657
QWEST LCI	Q.BIZ	4.9%	\$77	\$337	\$657
SPRINT	BUSINESS SENSE **	4.9%	\$81	\$347	\$678
WORLDCOM	INTELENET	4.4%	\$92	\$410	\$795

*Drops to 4.9% for businesses that spend more than \$500/month.

**Analysis includes a 20% discount for Fridays Free promotional program.

DATA: BEACON RESEARCH GROUP

with a \$10 monthly minimum requirement, which we would avoid at such low levels of use.

It's worth noting that the new carrier-line charges represent a substantial portion of the final bill—about 15%—when call volume is this low. But the differences among carriers are small. AT&T charges \$2.50 a line vs. \$2.75 for the rest of the companies.

In our middle scenario, we looked for the most competitive plan for about 2,500 minutes of interstate calls each month and used eight phone lines. Frontier's EZ Plan came in lowest here, with a billing rate of \$330 a month. The \$10 monthly minimum is sure to be met under this scenario, so that's not a concern, and a five-second misdialed call will bill at 18 seconds instead of the half-minute that other plans featured.

Our final example is for a company that bills about 5,000 minutes a month, using 10 lines. Excel Communications Inc.'s Prime Business Select 3 stands out at here, with a monthly billing rate of \$625 a month. With its tiered rate structure, Excel's plan allows companies to benefit from lower rates if they rack up more calls, but they are not

required to meet any minimum billing level. And lest you think our penny pinching doesn't matter, consider that Excel's Prime Business Select 3 will save you more than \$1,100 in the course of a year over AT&T's plan.

Keep in mind that these rates are based on a snapshot of this fast-moving industry and on prevailing prices as of midsummer. Subsequent discounts and rate cuts may make some of these deals more attractive. But these special rates need to be tracked to ensure that they are actually applied. Kevin Bartlett, sales and marketing manager for Manchester (N.H.) database manager Tolles Communications Corp., wrangled an attractive rate from Excel Communications but found that, over the past year, he has had to jump through hoops to get \$6,000 in credits for discounts he didn't receive.

"I literally can say that on one billing problem, I talked to 38 people, and the issue is still not resolved," Bartlett says now. "It's not an easy process." His advice: Get the discount promises in writing, a tactic that has helped him in the past. Says MCI spokesman Brad Burns: "Obviously, we apologize if the customer has had a bad experience and we will take any action to ensure that the bill is corrected." Who knows, maybe you can find savings like that if you scrutinize your phone bill. Consider this your wake-up call.

By Mie-Yun Lee, editorial director
BuyersZone (www.buyerszone.com),
Boston

For more information about long distance rates, go to enterprise.businessweek.com or America Online at keyword: BWEnterprise.

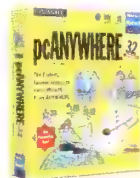
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Adeo Ressi, the CEO of methodfive, a Web development firm in lower Manhattan, still remembers the great battle of the stereos. His 30 employees were merrily working in their loft space one day last spring while British pop music boomed from their imposing sound system with its 4-ft-high speakers and 100-disc CD changer. Across the room, employees of MY-CD, a tenant that creates customized CDs, thought they would express themselves, too. They cranked up the volume on their country western fare. "It got pretty rough," concedes Ressi. Eventually, the conflict was toned down with headphones at MY-CD and more respect all around.

These days, CD players are standard in most PCs, audio streams in from the Web, and offices are becoming more casual. "Music keeps people creative," says Marsha N. Cook, a principal at Hendrick Associates, a 30-person architectural firm in Atlanta. "I don't want people getting too edgy."

But how do you keep the workplace harmonious when music is wafting freely through the corridors and employees are arguing over Handel vs. Hendrix? Greet Street, a San Francisco electronic greeting card company, prides itself on its free-wheeling atmosphere where tattooed programmers and straight-laced business strategists work side by side. But the office sound system soon became a source of constant discord, says co-founder Tony Levitan. "We battled over the type of music, anywhere



DOWN TIME

Office Music: How To Keep the Peace

ONCE YOU ESTABLISH THE ETIQUETTE, YOU CAN START TO WORRY ABOUT THE REPERTOIRE

from grunge to Vivaldi," he says. Over time, Greet Street moved its employees to headphones. That satisfied most people, but left the business staff with the occasional grumble. "A lot of my work entails talking on the phone," explains Samantha Cho, Greet Street's director of corporate sponsorships. "It's difficult to

immerse myself in music."

Of course, where private offices abound, musical taste is a nonissue. But in open-plan offices and Dilbert-style cubicle farms, most employees either have to adopt the "mission-control" headphone look or rely on small speakers plugged into their computers with the volume turned down low.

The most cutting-edge listeners are pulling their sounds off Web sites that offer a huge menu of options. (It works best with a continuous, high-speed Net connection.) For example, VTuner.com gives users ac-

cess to radio stations worldwide. Just click on a station selected from the index. If you've already downloaded the RealAudio plug-in, you're in business within minutes: listening gratis to a sonata on Radioemoras Beethoven in Santiago, Chile, or grooving to funk on Radio Free Orleans in New Orleans. Then there's Spinner.com, which hosts 125,000 visitors a week, most of whom click in from work to choose among 100 preprogrammed sound tracks such as movie scores and gospel. At SongHits.com there's even a "tension relief" section that features Barbra Streisand singing "The Lord's

Prayer" and various works by the master relaxer, Yanni.

But is it healthy to let your employees work to nonstop music? Don G. Campbell, a corporate consultant, lecturer, and author of *The Mozart Effect*, which details the emotional and physical benefits of music, doesn't think so. He recommends musical interludes, especially after lunch and during the late afternoon, as an energizing break. But, says, they should last no more than 20 to 30 minutes. "What's not healthy is keeping on talk radio or music day in and day out," Campbell says. "Our ears have work to cut out sound."

That wisdom notwithstanding, methodfive continues to subsist on a continuous diet of mostly rock, jazz, and techno. "The music makes it seem a lot more playful," says Dave Prior, project manager. Also, the company's huge stereo system offers a hidden incentive for employees to arrive early: First one in gets the pick of CDs. Now that's sound management.

By Dennis Berman
New York

HARMONY Web musical offerings are plentiful, but silence should be, too

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IS YOUR REPRODUCTIVE SYSTEM IN DANGER?

The U.S. plans a controversial test of some 87,000 compounds

In September, the Environmental Protection Agency will start seeking public reaction to one of the largest environmental testing programs ever. Under congressional mandate, the agency proposes to screen some 87,000 compounds over the next two years, at a cost to the chemical industry of more than \$100 million. It's all aimed at settling a scientific debate stirred up two years ago when some researchers argued that widely used chemicals might be having disastrous effects on the reproductive systems of both humans and animals.



But scientists are far from unanimous about the damage these chemicals might cause. Indeed, the most recent evidence suggests that the problem has been overstated. Granted, worrisome reports have continued to appear (table, page 18). Earlier this year, researchers reported that the ratio of male births to females in some groups is dropping. Girls were found to be reaching puberty much earlier. The incidence of male genital birth defects is rising, and rates of breast and testicular cancer are soaring. The most heated debate centers on a controversial set of data that may or not indicate that male sperm

counts are declining worldwide; the latest analysis says they are.

While some researchers believe these findings are the result of exposure to at least a few of the chemicals the EPA is about to begin testing, others take a far more cautious position, arguing that the evidence is still highly uncertain. And new studies reported at the meeting of the American Chemical Society in August did little to resolve the debate.

Researchers reported finding a sharp decline in the amphibian population in areas of the Sierra Nevadas with heavy concentrations of

pesticides. They found an increased incidence of non-Hodgkin's lymphoma in women with high levels of exposure to polychlorinated biphenyls (PCBs), a now-banned chemical used in insulation. On the other side, however, researchers said that no link was found between breast can-

cer and PCB exposure. Nor could the Food and Drug Administration find evidence to support the theory that some chemicals were seeping from packaging into food.

The EPA's daunting task is to settle the issue—despite the fact that scientists have yet to agree on the best ways to test for these chemicals. "This is a very controversial issue at the cutting edge of science, and the EPA is right in the middle," acknowledges Gary E. Timm, a senior technical adviser to the agency's chemical division.

HUGE UNDERTAKING. The cause of all this concern is a class of synthetic chemicals referred to as endocrine disruptors. They are suspected of doing damage by chemically mimicking hormones and interfering with the endocrine system, which controls reproduction and other bodily processes. The compounds range from such widely recognized chemicals as DDT and PCBs, banned in the U.S. and Europe, to chemicals used in virtually every plastic container and detergent (table). Similar hormone-mimicking chemicals also occur naturally in whole grains, soybeans and many fruits and vegetables, part of the reason that some critics say the concern is overblown. If the synthetic chemicals are guilty as charged, it would be a huge undertaking to phase them out; most have become part of the very fabric of modern life.

Scientists have been studying potential endocrine disruptors in earnest for the past decade. But the issue was blown into the public eye by the 1996 book *Our Stolen Future*, written by Theo Colborn, a biologist with the World Wildlife Fund, and two co-authors. The authors gathered a wealth of data on birth de-

COMMONPLACE SUSPECTS

The following chemicals, used in a wide variety of products and industrial processes, are possible endocrine disruptors:

	USES	CONCERNS
PHTHALATES	Plastics, vinyl flooring, adhesives, food packaging	Possible link to low sperm counts, miscarriages, and breast cancer
ALKYLPHENOLS	Industrial and domestic detergents, some shampoos	Mimic estrogen, possibly causing hormone-related illnesses
BISPHENOL A	Resins that coat food cans	Mimics estrogen; linked to reduced testes size in rats
ORGANOCHLORINE PESTICIDES	DDT, still used in developing countries	May increase breast cancer rates and block male hormones
DIOXINS	Produced during incineration and some industrial processes	May mimic estrogen

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STORY #194:

My Wonderfully Predictable Future

LET'S just say you're the CEO of a large investment firm. You've got one eye on NASDAQ, one eye on Dow Jones and four hundred hands trying to grab the best stocks in both. You also know you have to face two hundred employees who want more money, better coffee, a parking place and notebooks that can handle a volatile market.



[*"Risk is okay in my line of work, but I sure don't need it from my notebooks,"*]

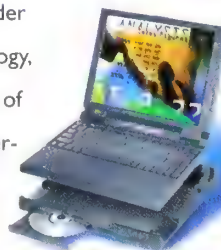
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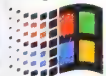
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toxicological information and regulatory policies also guided the process of screening chemicals. The final report, released in May-President Al Gore said the report was "a landmark document that will be instrumental in the testing of chemicals."

But several of the studies cited in the report have not been widely duplicated. The first, a 1992 study published by Danish researchers, concluded that male sperm counts had fallen throughout the 1970s and 1980s, from 1980 to 1990. The study was based on a survey of 100 sperm donors from 1973 to 1990, the years covered by the report. When other researchers repeated the study using different statistical measures, they found no decline. The latest study, by the California Health Services Dept., did find large intraregional differences. But their study did not look for a cause, and further studies are needed to determine whether endocrine disruptors are responsible.

Science is still a long way from making a determination. Chemists admit that many exposures to chemicals appear to interact with the

endocrine system, and there is no sure-fire way to screen for them. Also to be determined is whether these chemicals affect humans and animals differently. The question of safety is urgent: before a chemical becomes dangerous, and the effect on fetuses. "The science is moving very, very slowly," says Timothy P. McNeal, a senior researcher with the FDA. "We still don't have good evidence data, so interpretation is difficult."

FALSE POSITIVES? Even so, the EPA has to do the job to protect people. The Food Quality Protection Act of 1996 requires it to screen all chemicals found in food and drinking water for endocrine disruptors. The EPA plans to start this year by sorting through 10,000 chemicals in common use, narrowing them down to 1,000 that are the most likely to disrupt the endocrine system. By the end of 1999, the agency plans to test all 15,000—at a cost to the manufacturers of about \$200,000 per chemical—to see which are most likely to interfere with hormones. Then comes a third round of tests on the strongest suspects, looking at their impact on lab animals, at a cost of about \$2 million a pop.

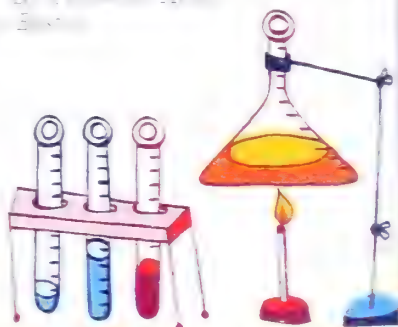
Chemical industry advocates are already on the offensive. Christopher J. Bergert, president of the Florida-based consulting firm Applied Environmental & Technical Sciences, says the screening tests are likely to be unreliable—and will create a lot of false positives. "This is clearly a situation where the regulators have got way ahead of the science,"

complains environmental lawyer Terry F. Quill of the Washington law firm Beveridge & Diamond.

But plenty of scientists argue that the potential dangers are too serious to wait. "Look how long it took to agree on global warming," says Dr. Ann M. Soto of Tufts University School of Medicine, who started studying endocrine disruptors in 1989 after chemicals contained in plastic test tubes spoiled her estrogen experiments. "On this we cannot wait until the data is here," says Soto. "I'm speaking as a citizen, not a scientist."

Scientists already tend to be cautious. John Brock, a biologist with the Centers for Disease Control, says he knows firsthand the dangers of a rush to judgment. To his surprise, he recently found a five-fold increase in non-Hodgkin's lymphoma among women exposed to high levels of PCBs, but no strong association between PCBs and breast cancer. "Although I'm very concerned about these chemicals, we have to be very cautious in how we proceed," Brock says. But even he feels the EPA must move ahead with its testing plan. "We're doing this for our children and our children's children." Which could be worth a lot more than \$100 million.

By Catherine A. Mason
and Susan E. Hays



CONFLICTING EVIDENCE

Environmental advocates are growing ever more convinced that chemicals suspected of disrupting hormonal signals in animals and humans

SEPTEMBER 1998 EPA to begin hearings on a plan to screen 15,000 chemicals suspected of being endocrine disruptors.

AUGUST 1998 A Centers for Disease Control study finds a five-fold increase in non-Hodgkin's lymphoma among women exposed to high levels of PCBs, but no strong association between breast cancer and PCBs.

AUGUST 1998 After an earlier report of declining sperm counts in a group of Finnish men, a report by David Lave and other scientists published in *Environmental Health Perspectives* says that declining sperm counts are also related to other factors, raising the possibility of other causes.

APRIL 1998 Japan reports high levels of chemicals that can affect the reproductive system have leached from packaging and food.

MARCH 1998 The World Resources Institute reports that the ratio of male births to female has been declining slightly since the 1970s in the U.S., Canada, and Europe. Scientists are divided over whether chemical pollutants are the cause.

JANUARY 1998 A reanalysis of a controversial 1992 study of declining human sperm counts finds significant declines in the U.S. and Europe over the past 50 years, but not in Japan, where the evidence is not conclusive.

NOVEMBER 1997 The Centers for Disease Control and Prevention publishes data showing a doubling of the incidence of genital birth defects in U.S. males.

AUGUST 1997 The European Environment Agency issues a report concerning rising reproductive abnormalities in both animals and people, including fish that have both male and female sex organs, and dramatic increases in breast, testicular, and prostate cancers in humans.

FEBRUARY 1997 The EPA reviews nearly 300 studies and concludes that hormone-disrupting chemicals can lead to disturbing health effects in animals but says the evidence in humans is uncertain.

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A person with dark hair, wearing a red long-sleeved shirt and black pants, is captured mid-air performing a backflip. Their arms are outstretched, and their legs are bent. The background is a solid, deep blue. The text "The color of trust." is printed in a gold, serif font in the lower right quadrant of the image.

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Developments to Watch

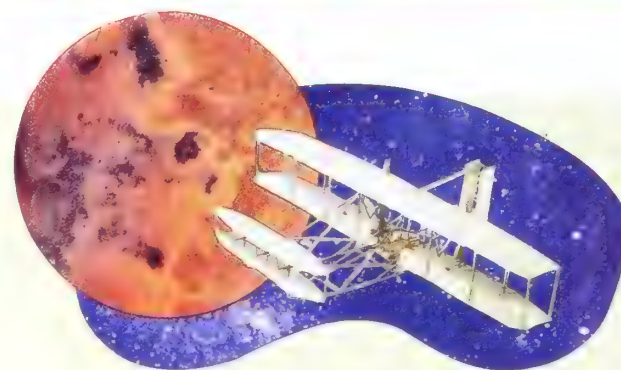
EDITED BY OTIS PORT

A ROMP AROUND THE RED PLANET—IN AN AIRPLANE

AFTER ORVILLE AND WILBUR Wright made aviation history at Kitty Hawk, N.C., in 1903, their feat initially met with widespread disbelief. Today, a plan to commemorate that flight in 2003 is also raising eyebrows.

Engineers at NASA's Ames Research Center in Mountain View, Calif., want to emulate the Wrights' achievement—by launching the first plane on Mars. The estimated tab: \$48 million.

The Ames team, led by Lawrence G. Lemke, chief of advanced projects, has already designed a robot plane and dubbed it Kitty



Hawk. It would be carried to the Red Planet like the Mars Rover but launched in the air, as its spacecraft parachutes through the atmosphere. Kitty Hawk would carry cameras and sensors like those used on Earth for aerial surveys and mapping mineral deposits—and relay images far more detailed than those from satellites. The main target is Valles Marineris, a canyon more than 100 times

bigger than the Grand Canyon whose formation has so far defied geological explanation. Images from the flight's final minutes would be even more detailed, because Kitty Hawk would glide to a crash after three hours and 1,000 miles.

Kitty Hawk is among some two dozen ideas now competing for \$300 million so-called Discovery mission funding. NASA expects to pick the winners next May. □

INNOVATIONS

■ In a serendipitous discovery, scientists at Lawrence Berkeley Laboratory and the University of California at Berkeley may have found an inexpensive material for making windows more energy-efficient. While working on a way to boost the performance of a rechargeable battery, they put a transparent film of nickel hydroxide and titanium dioxide on glass. Surprise: It works like photochromatic eyeglasses, adjusting its opacity according to the brightness of light hitting it.

■ Automated translation of phone calls has long been a dream of telephone companies. Now, AT&T and Japan's Advanced Telecommunications Research Institute have joined up to make it come true. By the end of next year, they expect to have a prototype system that will automatically translate spoken Japanese into English, and vice versa.

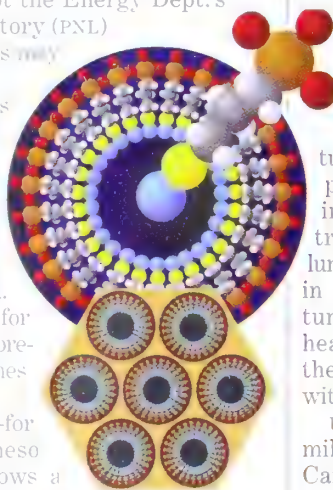
RESEARCHERS DRAW A BEAD ON TOXIC WASTE

HUNGRY MOLECULES INHABITING PORES IN MINUSCULE CERAMIC beads could soon be cleaning up vast amounts of contaminated soil and water. Researchers at the Energy Dept.'s Pacific Northwest National Laboratory (PNL) in Richland, Wash., believe the beads may be the best pollution fighter yet.

Once for ounce, the ceramic beads can gobble up more mercury or lead than anything else, says PNL scientist Jun Liu. It's hard to imagine, he explains, but a tablespoon sprinkled on a hazardous-waste site would act like a "sponge" with a surface area as big as a football field. And the molecules can be tailored for industrial chores, such as extracting precious metals from wastewater at mines and metal-finishing plants.

The technology is called SAMMS—for self-assembled monolayers on mesoporous supports. The drawing shows a hexagonal section of porous surface. In the closeup on top, a molecule with oxygen, carbon, and hydrogen atoms (red, gray, and white, respectively) ends in a thiol group (yellow) that has latched onto a mercury ion (blue).

PNL is working with Mobil Corp., which developed the process that stuffs the ceramic pores with molecules. And 3M is working on ways to embed beads in conventional membrane filters. Next year, PNL expects to launch SAMMS demonstration projects for metal finishing and mining. □



'TRAINING' CELLS TO FIGHT CANCER AND OTHER DISEASES

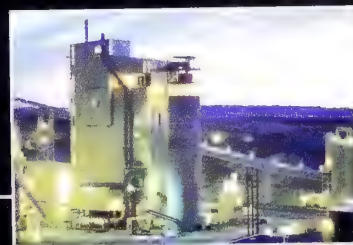
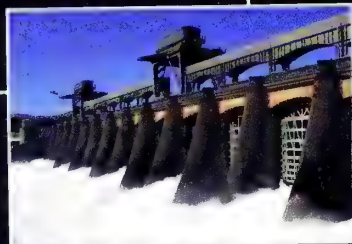
DENDRITIC CELLS ARE THE pacesetters of the human immune system—they regulate the activity of immune cells in lymph nodes. Now these white blood cells may be harnessed as the building blocks for potent therapeutic cancer vaccines.

Researchers at the University of Pittsburgh Medical Center (UPMC) are "training" dendritic cells to target specific tumors afflicting individual patients. The researchers are able to do that by culturing the cells with synthetic peptides that mimic a protein from a patient's tumor. When the altered dendritic cells are then injected into the patient, they activate T-cells and other disease fighters to attack tumor cells throughout the body. "Our goal is to create a less toxic and more effective therapy," says surgical oncologist Michael T. Lotze.

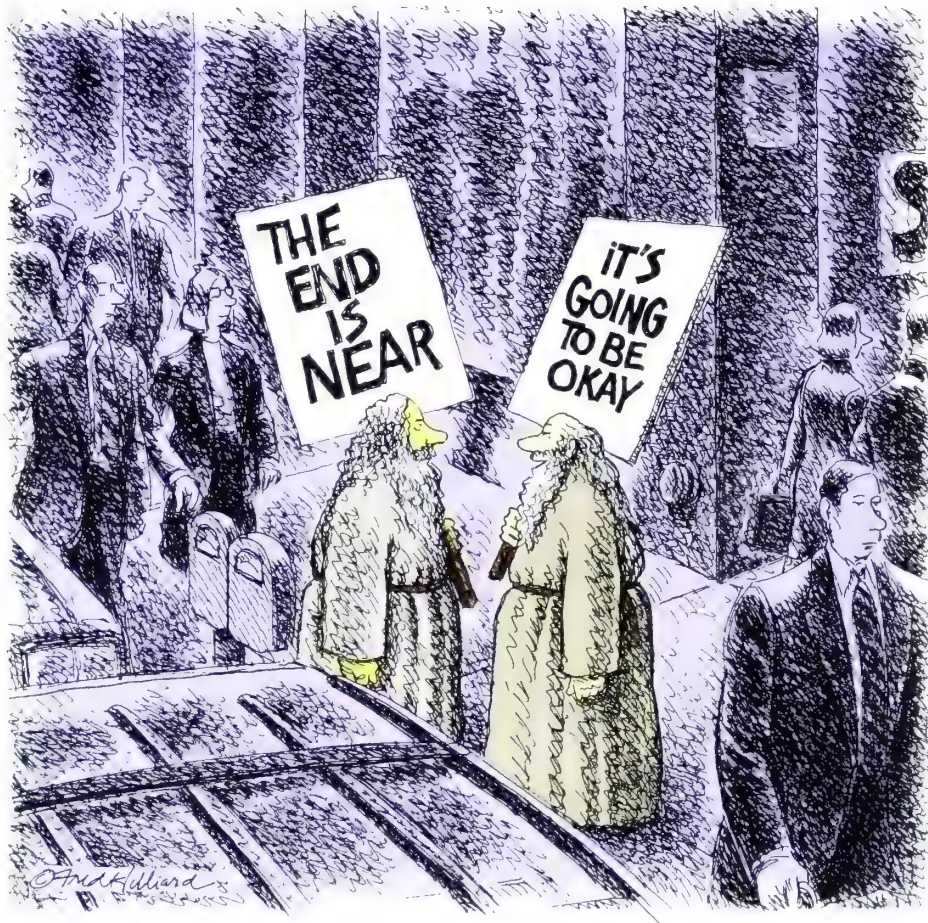
Limited human trials at Pittsburgh's Cancer Institute clearly show promise. In the most dramatic cases, melanoma tumors disappeared in two patients. In studies involving mice, dendritic cells trained with melanoma lung carcinoma cells resulted in vaccines that prevented tumors from growing in healthy mice—and shrunk the tumors in 80% of mice with cancer.

UPMC recently received \$1 million from the National Cancer Institute to expand its dendritic-cell research. Other Medical Center researchers hope dendritic cells can boost the immune system's response to HIV, the virus that causes AIDS, and human trials aimed at HIV are scheduled to begin this fall. *Johanna Knapschaef*

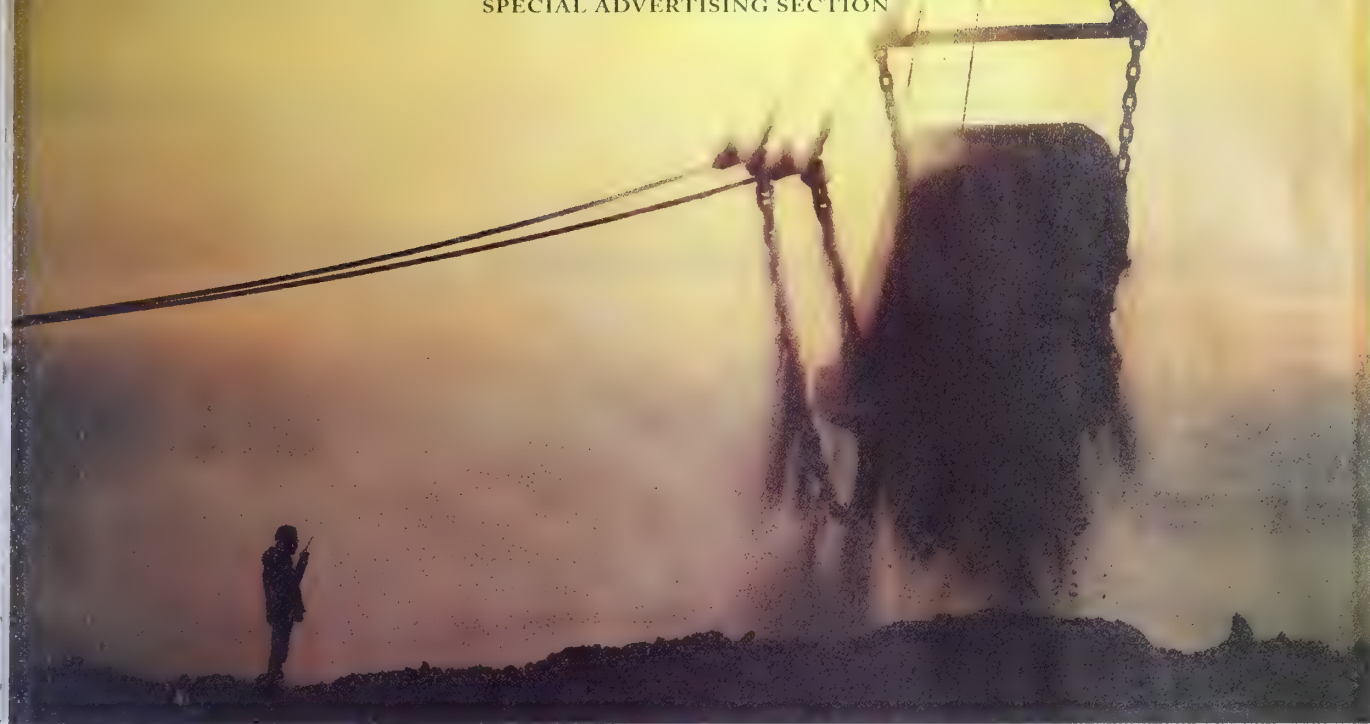
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Energy—from crisis to opportunity

Twenty-five years ago, high fuel prices and fears of resource depletion led to a world energy crisis. Today, energy prices have declined in real terms and technological progress and new resource discoveries are expected to keep energy prices low in the near term. It is even possible, according to the World Energy Council (WEC), that long-term real energy prices could remain constant worldwide.

Energy companies today compete in a world marked by market liberalization, increased globalization, and swift technological change.

Water, gas, and electricity companies are becoming increasingly active in each others' markets, and in some cases, electricity companies have used their electricity distribution networks to create their own telecommunications infrastructure.

Meanwhile, the need for electricity, modern transportation systems, and other services provided by energy in both developed and less developed nations leads to a number of concerns that extend beyond the scope of energy companies: with a world population set to double in the next century and energy demand set to quadruple, how can the huge new need for energy development be financed? What environmental costs will be associated with the growth in energy demand?

How will less developed nations be able to mobilize resources to meet the energy needs of their growing populations?

By 2020, annual investment requirements into the energy sector could run from \$1.2 trillion to \$2.1 trillion, with electric power generally accounting for two-thirds of the investment requirement according to research conducted on behalf of London's World Energy Council (WEC).

Until the late 1980's, the power sector was owned and financed by governments in most countries outside the United States. The idea of competition in power was regarded as unworkable and inappropriate. Nevertheless, with governments, especially in developing countries, less willing and able to underwrite the activities of the electricity industry, newly privatized utilities and energy companies have had to turn more aggressively to structured finance markets to raise money.

The 25 largest international power developers are expected to commit more than \$40 billion of equity to international power developments in the next five years, according to estimates made by N.M. Rothschild & Sons. This will be increased three or four-fold through the use of acquisition and project finance debts and bonds. "It turns out to be perfectly feasible to privatize electric power within a set of policy rules that protect the national interest and the consuming public while transferring ownership and responsibility for financing to the private sector," according to Sir Evelyn de Rothschild, chairman of N.M. Rothschild & Sons.

Global capital resources in principle are more than adequate to meet any potential demands coming from the energy sector, according to a WEC report on financing the global energy sector. The WEC suggests that, as has been the case for a number of decades, these demands are unlikely to exceed 3%-to-4% of global output.

Where energy is produced for domestic consumption, most of the financial requirements will have to be met by domestic resources, according to Anthony Churchill of the Washington International Energy Group and chairman of the WEC study committee on finance.



*Tony Churchill,
Washington International
Energy Group*

**"THE SECTOR IS TOO
LARGE RELATIVE
TO THOSE ECONOMIES
TO RELY HEAVILY
ON INTERNATIONAL
CAPITAL WITHOUT
ENCOUNTERING
BALANCE OF
PAYMENT PROBLEMS."**



*Douglas Hyde,
president,
Green Mountain*

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FIGURE OUT WHAT
CUSTOMERS WANT
AND THEN GIVE IT
TO THEM."**

The energy sector of developing countries is too large relative to those economies to rely heavily on international capital without encountering balance of payment problems, he said. On the other hand, he added, international private capital could play an important role in the development of domestic capital markets as well as in assisting in improving management and transferring technology.

The major issue is how to mobilize capital. The capital mobilization problems faced by many countries are not affected by assuming lower or higher levels of growth. What is affected is the ability to harness local capital and the sense of urgency with which the existing constraints need to be addressed. Contrary to popular belief, savings rates in many developing countries are double those of the United States and generally one-third greater than those of Europe and Japan. WEC research suggests that national savings in many developing nations is sufficient to finance national energy development.

Most of the difficulties of energy financing have special force in relation to the least developed countries. Two billion people in the developing world have yet to be reached by commercial energy and have little prospect of this occurring unless fundamental measures are implemented.

For example, although Africa is impressively endowed with energy resources, the development of commercial energy is constrained by the generally poor state of economic development, inadequate infrastructure, external indebtedness, and political and civil unrest. Africa with 13% of the world's population currently consumes 3% of its commercial energy.

Liberalization

Markets are opening throughout the world. In Europe, electricity generation, transmission, and distribution monopolies will be broken down and the market opened to competition with the European Directive on liberalization, Directive 96/92, which comes into effect February 19, 1999. Through the directive, customers in most European countries will be able to choose their energy supplier and will be allowed third-party access to electricity and gas networks.

The liberalization of the market in Europe has been embraced for two reasons. First, current technologies allow for the building of small, efficient power plants,

so huge initial investment is avoided. In addition, a plentiful supply of cheap gas allows these electricity generating plants to operate economically. The combination of new technologies with low fuel prices have lead to projections for aggressive growth in the energy sector.

Liberalized markets tend to favor two kinds of companies, according to Graham Ward, deputy chairman, World Energy Group, Price Waterhouse, London, large multinational energy companies well positioned to win in the global power market liberalization, and small local niche players in the same position.

Multinationals have the size and financial resources needed to break down the high cost barriers to entry into new markets, Ward said, and to establish portfolios of operations able to mitigate and balance the higher economic and political risks that liberalization usually produces. Small niche players, generally unsaddled with sunk costs, are able to respond swiftly to local markets as they open.

The WEC report, "The Benefits and Deficiencies of Energy Sector Liberalization" demonstrates that liberalization, by introducing competition, leads to reduced costs, increased efficiency and better service to customers. Liberalization facilitates investment, especially in developing countries where funding is vital for economic growth. Liberalization also puts energy decisions in the hands of objective market forces, keeping them away from the often subjective influence of government.

The customer is king

In the new liberal environment for the energy sector, where customer choice becomes more important than it was for traditional utilities, companies are finding that a customer base represents a complex and diverse set of social and political opinion. They also are finding that offering economic incentives is not enough. Some energy customers, for example, want to ensure that the power they receive is not being produced in ways that endanger the environment. In some instances, customers have signaled a genuine willingness to pay a premium for power from a supplier using only renewables and other production processes that do not harm the environment.

Serving such niche markets represents a genuine business opportunity for small

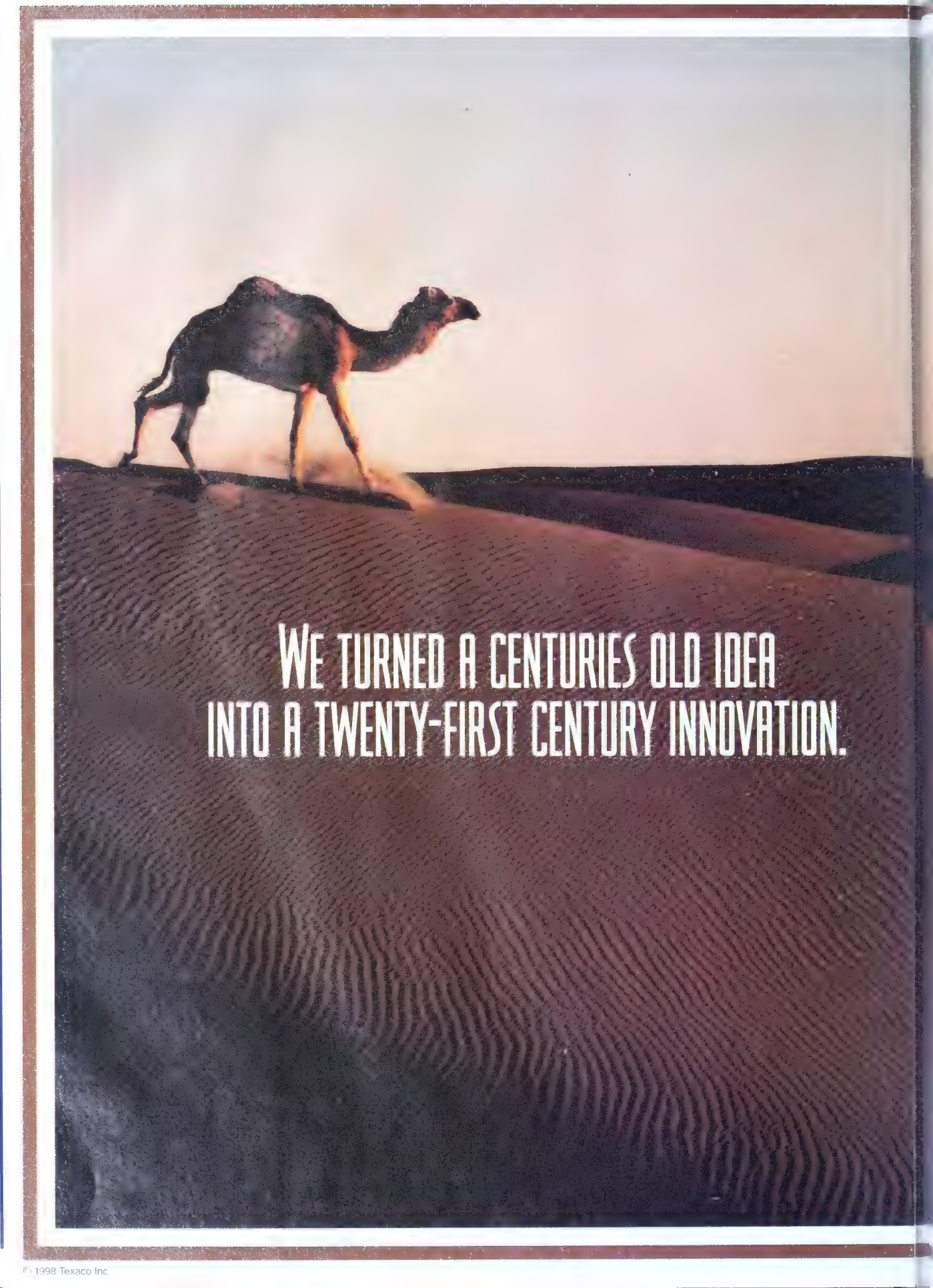


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A full-page photograph of a camel walking across a sand dune. The camel is silhouetted against a bright, hazy sky at sunset or sunrise. The sand dune in the foreground has distinct, wavy ripples. The overall mood is serene and evokes a sense of enduring tradition.

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A WORLD OF ENERGY.

players in the energy business. In Vermont, for example, Green Mountain Energy Resources, of Burlington, is making a drive to sell power from small hydroelectric, wind, geothermal, and biomass projects to environmentally conscious home and apartment dwellers. "You've got to figure out what customers want and then give it to them," according to Douglas Hyde, Green Mountain president. "The mental trick with electricity is to stop thinking of it as a commodity and to start thinking of it as a consumer product," he said.

Globalization

In the newly liberalized and expanded global industry, energy companies will need to develop strategies for dealing with governments.

A government's willingness to sell off its power plants should not be equated with its willingness to create a liberalized electricity market. It will require the active support of a country's president and finance, labor and energy officials to provide the authority to regulate and police the market. Otherwise it may be difficult for independent power projects (IPPs) to achieve their financial goals.

As governments liberalize their energy sectors, they should try to apply universally accepted rules to the multiple and complex issues involved in restructuring, advises Enrico Testa, chairman of Enel SpA, Italy's national electricity generator. Testa, addressing energy ministers from the G8 countries at an economic summit meeting in Moscow earlier this year, said government energy ministers should tailor restructuring plans to take into account the impact of globalization on national energy sectors, energy-supply security, and environmentalism.

To make an energy market more efficient, a government must dismantle its private and public monopolies, and become the regulator rather than the owner of its supply network, argues Testa. Transparent pricing, nondiscriminatory access to the supply network, elimination of market distortions and financing research and development are the essential components of an efficiently restructured energy sector.

Inherently, Testa said, globalization improves the security of national energy-supply sectors by introducing competition by multiple suppliers. By not crafting rules specifying which kinds of power plants can be sited where and how electricity can be transmitted, they can avoid

**"TECHNOLOGY
IS ADVANCING
EXPONENTIALLY
AND IT
WILL ONLY
ACCELERATE."**



*Don D. Jordan,
chairman and CEO,
Houston Industries*

creating an environment in which market forces cannot do their job and in which suppliers' business creativity is stifled.

Technology

The production and utilization of energy will require massive new investments in both developing and developed countries, said Don D. Jordan, chairman and chief executive of Houston Industries. "Whether these investments ultimately promote an economically robust and environmentally sustainable global economy depends in large measure on the energy, environment, information, communications, and related technologies that are put in place," he said.

"Technology is advancing exponentially and it will only accelerate. For example, we've seen prices for large-scale combined-cycle plants plunge almost 45% from where they were in the early 1990's. Capital costs have dropped as manufacturers have improved technology and increased the power density of their gas and steam turbines. The results have been a win/win situation with lower prices, increased efficiency, and more environmentally friendly choices," he added.

Twenty years ago, the wind energy industry was developing wind turbines of several megawatts in size, with strong government support that resulted from the crisis mentality of the 1970's. But the

market never responded. Technology development had leaped ahead of the market's appetite for technological risk.

Today, though, wind energy companies have progressively designed, built, and operated a series of commercial turbine/generators that only now are approaching even one megawatt in individual unit sizes. But these units are installed and operating across the globe. In the aggregate, they amount to a minuscule amount of electric energy, compared to fossil, nuclear, or hydroelectric energy, but wind is one of the fastest growing sources of energy.

The old system encouraged large, centralized power generators because of economies of scale, but also because they fit the traditional utility business model. Utilities made much of their money by investing in large capital projects, and building the robust infrastructure that all of us enjoy today, but not necessarily on operating the system in the most efficient way possible.

Today's model—based on private ownership of generating plant, equitable access to the transmission grid, and regulated transmission and distribution companies—could open the market to a concept called distributed generation. The analogy here is mainframes and personal computers. Small, dispersed power systems could play a large role in providing incremental, financeable electric capacity, and in stabilizing the transmission and distribution grid.

This is not to say that large, central plants will disappear. Instead, the new energy industry models allow both to coexist and compete.

Technologies such as gas and diesel engine/generators are being upgraded with advanced controls and automation, new combustion schemes that bring ultra-low emissions, and more durable, reliable materials to withstand the rigors of more frequent service. Gas turbines have also been "miniaturized" to create micro-turbine/generator power systems with efficiencies unheard of in this size range two decades ago.

Fuel cells, which essentially convert the chemical energy of a fuel such as natural gas directly into electricity, also could find an important niche providing electricity to on-site businesses. Fuel cells are a very clean way to produce electricity, especially in small quantities because no combustion occurs.

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New technologies will assist in building wider transmission grids to carry electricity.

As with wind turbines, the active development of fuel cells in the 5 and 10 megawatt range was a response to the energy crises. The idea was that the bigger they got, the more attractive they'd become to traditional utilities, working with the centralized plant, centralized control model. Now they are largely commercial in sizes that the emerging market can bear—more like 250 kilowatts in single unit sizes.

The newer versions of these distributed power systems are smaller, more efficient and more versatile. On the surface, they are being made to look more like an air-conditioning unit, and operated more like a home appliance. With the minimum amount of attention and maintenance, ultra-low environmental-impact profiles, and a high degree of automation. Distributed power can bring the concept of on-site, reliable electric energy to businesses as small as fast-food franchises.

Renewables

Even more exotic energy sources, like solar photovoltaics, are being reexamined. The intensive development programs of the 1980's are no longer occurring, but electricity suppliers in the new market may find that rooftop photovoltaic systems a profitable niche for serving rural, remote customers too expensive to serve with a distribution line. Additionally, users who may want to function off the grid, or have an alternative to grid power, may find these small systems attractive.

Many of the large energy companies, who built their businesses on petroleum and natural gas were heavily invested in solar and renewables subsequent to the energy crises of the 1970's, then divested as the crisis subsided and energy prices plummeted. Today, these same companies are investing in renewables again as business and technology have moved to make renewables a profitable pursuit.

Merge and compete

Already, major natural gas companies and electricity companies have merged and this trend is expected to continue. Where mergers have not occurred, each has learned the other's business well enough to have some ability to cross over if the right opportunity presents itself. Generally, there are technical efficiencies to be gained from integrating operations. As one example, gas companies operate and maintain gas turbines on transmission lines. Power companies operate and maintain gas turbine/generators. For the most part, the machines are the same and can benefit from economies of scale.

When electric companies merge, or at least cooperate across sovereign, state, or regional borders, efficiencies are raised, too, although the need for workers may contract. Interconnection of electricity grids in Europe, South America, and North America, a growing trend with its own technological advances, is being pursued with vigor. In essence, that means that energy sources in one region

or country can be balanced with other sources. Hydro-rich areas, for example, can supply cheap baseload electricity to other regions—and gain peaking and intermediate load power through a means other than building new plants.

Coal proponents have perhaps the most to gain from technical integration. Because of its heterogeneous nature, coal involves not only air emissions but solid waste discharges as well. Fortunately, much of this material can be recycled into industrial products, such as cement, building products, and others. Coal can also be fractionated, though at high expense, into higher value carbon-based products and commodity chemicals.

Energy Leaders to Meet in Houston

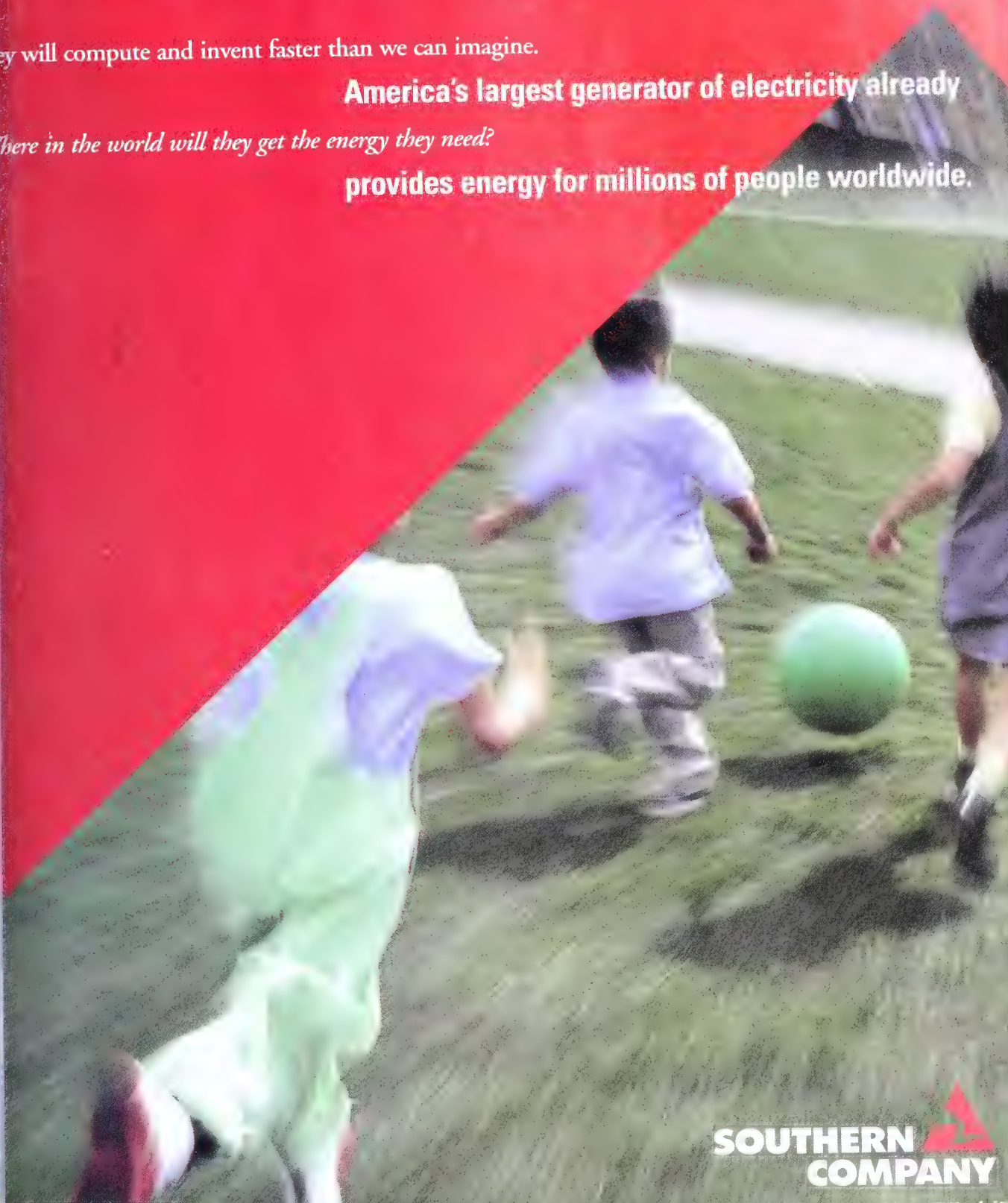
Every three years the activities of the World Energy Council (WEC)—a London-based international organization that promotes the sustainable and beneficial supply and use of energy—culminate in a Congress that brings together industry and government leaders to debate and discuss findings of the WEC's numerous study groups and committees. This year, the 17th Congress of the WEC is being held September 13-18 in Houston, and is being organized around the theme of "Energy and Technology: Sustaining World Development into the Next Millennium." Representatives of energy companies and government officials from more than 100 nations are expected to gather in Houston to explore the vast array of current and emerging energy-technology options that will shape world societies, economies, and environments for the foreseeable future. WEC Congress delegates will include chief executives and Energy Ministers from developed and developing nations. Traditionally, the conclusions and recommendations, made at the close of each Congress, go on to inform government policies and corporate decisions on energy matters for many years to come.

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Technologies must continue to be developed to make the coal-based powerplant an anchor for a multitude of needed industries. Large coal plants can support sulfuric acid production, fertilizer production, and wallboard manufacturing by recycling their air discharges into more beneficial byproducts. Some say that without such an "industry ecology" approach to the business, coal will have difficulty charting its energy future. As long as so-called premium fuels like natural gas and petroleum are competitively priced, coal can't maintain the long-term economic edge it had for years, decades even.

All types of powerplants can gain efficiencies and reduce environmental impact from technical and resource integration. One example is that many of the latest power stations take water discharged from a municipal or industrial treatment plant instead of sourcing from a river or lake. This so-called cascading of natural resources stretches their value among once-disparate industries, for the benefit of our environment.

Technology at the user end of the value chain does not supercede that at the exploration and production ends, though it is perhaps of more interest to the business community. After all, most energy consumers, despite green energy and other ways to distinguish a commodity, are no different from other classes of consumers: They want to flip a switch or turn a valve and forget about it.

Turbines power change

Gas-turbine technology, based on a machine, around for half a century at least, almost lost its market entirely twenty years ago because generating electricity with oil and gas was banned during the 1970's energy crisis. Now in its combined-cycle configuration gas for electricity dominates new capacity additions in the western world and in key countries in Asia.

Combined-cycle technology has gone from an overall efficiency in the mid-40% range in the early 1980's to the high-50% range today. And new machines on the verge of commercial production will allow the combined cycle to top 60% after 2000.

But the story here is not just one of technology but of the interplay between technology and business. Because of the competitive forces that came into play, structuring and financing projects worldwide, developers helped drive suppliers to ever

ENERGY RESOURCES

The liberal and global energy market is also affecting fuel choices being made in electricity generation and transportation. In many ways, the use of natural gas to generate electricity has revolutionized the industry, making it possible, through lower up-front investment costs, for independent power producers to participate more fully in the electricity generation business.

GAS

The current position and outlook for natural gas are highly positive, with reserves increasing and regional markets and international trade growing. The demand for gas is expected to grow dramatically in most countries. While world supplies are more than adequate, distribution requires capital intensive delivery systems either in pipelines or liquid natural gas. WEC estimates range from \$900 billion to \$2.6 trillion in cumulative investments from 1990 to 2020.

Natural gas consumption has risen by 35% since 1990 and accounts today for 20% of total primary energy requirements in Europe. Last year consumption was over 290 megatonnes (mtoe) and is expected to grow this year to more than 315 mtoe. Total European gas demand will grow by an annual average of more than 13% from 1997 to 2000, and more than double from then to 2020.

OIL

Liquid petroleum is the world's most important commodity. Since the previous WEC compilation three years ago, proven oil reserves have increased by 4%, supporting a 5.6% increase in output. While generally stable, oil prices have recently declined to levels not seen since the energy crisis of the 1970's. This has been the case because of higher OPEC quotas and uncertainty about economic conditions in the Far East and Iraq's future export volumes.

In addition, there appears to be a reasonably large oil reserve base that is expanding over time. In the past three years, proven reserves have increased by 45 billion barrels, despite production of some 75 billion barrels of oil and natural gas liquids. The reserve, according to some estimates, could support increasing world oil production into the next century.

COAL

The proven world coal reserve base is 1,011 billion mt. This includes anthracite, bituminous, subbituminous, and lignite qualities. Compared with oil and natural gas, coal has maintained its long-term position as the world's most widely available fossil fuel. Current annual production totals 4.7 billion mt in 72 countries around the world.

Coal is generally expected to continue supplying a large portion of the world's primary energy demand, especially in developing nations such as India and China. The future of both the production and use of coal depends to a large degree on technical progress. Mining techniques and upgrading processes need to be improved.

The financing difficulties for future coal production are largely confined to former Eastern bloc countries, India and China, where large public monopolies in production and transport dominate. Output is sold at prices that do not always cover costs, efficiency is far from international norms, and environmental degradation is a serious issue.

NUCLEAR

Worldwide uranium production continued to contract until 1994, despite the continuous growth in world uranium requirements. Production from mines could cover only about half of the material needed to satisfy demand.

High capital costs and in some countries a poor record of cost containment, together with a growing negative public perception, all result in increasingly unacceptable risks for private financing of nuclear power. Added to this are licensing and site location difficulties, waste disposal concerns and public vs. private liability issues.

HYDRO

Hydroelectric power generation continues to be the most important and economic renewable source of commercial energy worldwide. It plays an essential role in most regions of the world. More than 150 countries generate hydroelectric power. There is about 700 GW of hydro capacity in operation worldwide, generating 2,600 TWh/y. About half of this capacity and generation is in Europe and North America, but that is

changing as more hydro capacity comes on line in Asia and South America.

The main problem with hydropower lies in the nature of the public procurement process. In the construction of dams, politics and employment have played a greater role than cost controls and fiscal accountability.

BIOMASS

Bioresources are potentially the world's largest sustainable source of fuel and chemicals, comprising a renewable resource of 220 billion oven-dried metric tons of annual primary production. Nevertheless, despite the large energy potential of biomass, in practice only a few types of biomass feedstock can be regarded seriously as a potential source of energy because of economic and environmental constraints. Biomass traditionally has been associated with poor domestic households, but its use is growing as an important source of energy for industries in many parts of the world. Industrial countries use it for combined heat and power, electricity generation and space heating and other decentralized energy applications. In developing countries, biomass is the main source of energy for many cottage industries such as baking, textile manufacture and certain types of food processing.

more demanding efficiencies so that the economics of converting fuel to electricity would improve with each project. Suppliers in turn competed to design a machine with an incrementally better efficiency. Amazingly the emissions profile of these units got better and better.

The advances in technology showed up in other areas as well. These types of plants can be sited and built quickly, which means they are on-line faster producing revenue for their investors.

In fact, the whole process has taken on a life of its own, with some of the implications of global competition only now coming to light. The upshot is that owners, operators, financiers, and suppliers will have to manage technological risk much as they now manage political and financial risk.

Developments in the gas turbine arena apply in areas outside of electricity generation, too. More efficient gas turbines mean that natural gas is transported more efficiently from where it is taken out of the ground to where it is used.

One testament to the breadth of gas turbine technology: Most advanced power cycles include a gas turbine/generator in the equipment configuration.

IT is it

Almost like a huge piece of elegant wrapping paper, the exciting field of information technology (IT) is responsible for its own share of energy innovation. New IT and analytical tools are being applied to hedge one energy commodity or product against another. Optimization software is applied throughout the value chain to make workers and management more efficient. Automation advances relentlessly, today aided by sophisticated software and monitoring devices, to reduce the number of people necessary to run equipment at optimum efficiency.

Where did all the cost savings come from on the equipment supply side? IT played a huge role. Computer-aided design techniques, global sourcing assisted by the vast array of communications tools available, and teams of designers communicating and cooperating around the world in a continuous 24-hour workday, have slashed costs. In one sense, IT and global partnerships have created a continuous "production" line with three shifts,

only the shifts take place in daylight in different parts of the world!

Now, IT will increasingly be brought to bear on the customer side. Massive electricity trading systems are being designed and applied in different regions of the world. Remote monitoring will be used to ensure that customer-side energy consuming equipment and devices are operated to minimize the energy bill, which from the point of view of the world's population, would be the best outcome on increased liberalization, globalization, and technological change.

Compiled by David Brezovec and Jason Makansi, editors with McGraw-Hill Energy.

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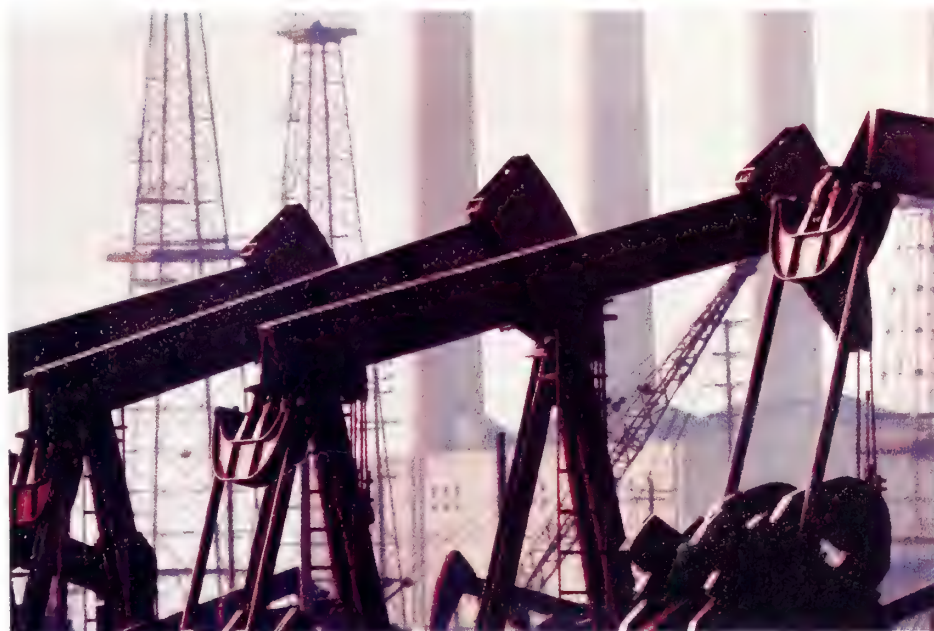
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PULLING US AIRWAYS OUT OF A DIVE



CEO Rakesh Gangwal's obsession with saving cash has helped turn the ailing airline into a moneymaker

Rakesh Gangwal doesn't talk much, but when he does, his words count. Recently holed up in a dim meeting room with two dozen execs, the president and chief executive of US Airways stood behind his chair, leaning chin in hand while pondering a delicate problem. A growing number of passengers had been complaining about rude service, particularly at the airline's international terminal in Philadelphia, where part-time workers make up 42% of the staff. After listening to the discussion for a few minutes, Gangwal quickly and calmly pronounced his solution. "Take the number of full-time workers up to 70%," he said in a matter-of-fact tone. End of discussion.

Gangwal, a slight man who speaks with a trace of an accent from his native

India, has been making dozens of swift yet coolly considered decisions since taking over as CEO last May. And over the past two years, since joining US Airways with Stephen M. Wolf, his longtime mentor and now chairman of parent US Airways Group, Gangwal has impressed the aviation industry with his resolute cost cutting and the role he has played in the quick turnaround of an airline that was once nearly bankrupt.

Along the way, his tough calls have brought no shortage of controversy. Last year, Boeing Co. sued US Airways for \$220 million, claiming breach of contract after the airline canceled an order; instead, the airline is turning to Airbus Industrie—which recently sold it options for up to 30 new jets—to build its fleet. (The Boeing suit has since been settled out of court.) Meanwhile, Gangwal's cost-cutting campaign has pushed frustrated unions to the brink. A quiet, disciplined man with an obsession for efficiency, Gangwal readily admits he is "driven to succeed." But, he is quick to add, "to me it is very important that my drive does not become an issue of

personal grandiosity." **GANGWAL:** *Can he take US Airways into the global elite?*

That may explain why Gangwal, 45, one of aviation's most influential leaders, remains so little known outside industry circles. The longtime No. 2 to Wolf, Gangwal deserves much of the credit for retooling US Airways into a profitable player ranked No. 1 in on-time arrivals. The pair have shut money-losing routes, inked a pilots' contract that saves \$88 million a year, and launched a low-cost shuttle, MetroJet. The result: Earnings in '97 soared nearly fourfold, to \$1 billion on revenues of \$8.5 billion.

DESTINATION EUROPE. A detail-driven man, Gangwal spends his days obsessing over load factors and yield management while Wolf has charted the carrier's broad strategy. Indeed, Wolf has gradually all but handed over the running of the airline to his protégé. With the pair now focused on European expansion, for example, Wolf is negotiating access with local governments while Gangwal tackles the nettlesome task

of actually entering the new markets.

If the turnaround has brought US Airways far, however, it remains a critical time. The carrier is well behind the giants as the industry consolidates. If it is to remain a strong, independent player, Gangwal must rebuild it into a carrier with global reach. That's why he's now deep into the numbingly technical details of combining US Airways' frequent-flier miles with those of American Airlines Inc. But larger rivals such as Delta Air Lines and United Airlines have long operated broader route systems and are bulking up even more through an array of partnerships.

It's all a long way from home for Gangwal, a native of Calcutta. The Gangwal family was decidedly middle-class, but India's poverty was never far from view. As a teenager, he volunteered with Mother Teresa, preparing medication for leprosy patients and collecting recyclables to earn money for the mission. The volunteer work provided an early lesson in frugality that has stayed with him after more than 20 years in the U.S. "Here we have these huge [trash] containers that are emptied regularly. I still can't quite get used to that" level of waste, he says.

Gangwal studied engineering at the elite India Institute of Technology in Kanpur. But he already had his sights on business—and that meant studying in the U.S. "I knew American universities had written the book on MBA programs," he says. He graduated with a degree in finance from Wharton in 1979. Gangwal has been working and living in the U.S. ever since, though he retains close ties to India, where his father, Kapoor, still lives. Gangwal has remained a vegetarian. When he married his wife, Shobha, in 1984, it was a union arranged by the couple's families. A U.S. citizen, he still visits India often.

HEADWINDS Gangwal is just starting to upgrade US Airways' fleet and archaic ticketing system. And even as he launches his no-frills MetroJet service, he's tussling with restless unions

Following a stint as an analyst at Booz-Allen & Hamilton Inc., Gangwal got into the industry in 1984 while working on a consulting job at United Airlines Inc. "When I joined United, I really thought I would work only a year or two, then do something else," he says. "I guess the jet fuel gets into your blood." By 1987, when Wolf was appointed CEO to revitalize the struggling airline, Gangwal was already on his way up. In 1992, Wolf put him in charge of planning, giving Gangwal wide-ranging

influence over the airline's strategy. "I noticed he was always prepared and, more important, he was right," says Wolf. He was also a quick study. Says Jack Ekey, then United's general manager of customer service: "I was absolutely astounded by the speed" at which Gangwal learned.

A good thing, too. Feisty Southwest Airlines Co. was moving aggressively into United's turf in California. More seasoned United execs were convinced the airline could rely on its higher-margin business traffic while leaving cost-conscious leisure travelers to Southwest. But Gangwal argued that United needed its own budget service to compete.

Gangwal kicked off the United Shuttle in Los Angeles and other big Western markets in 1994. He also slashed unprofitable East Coast routes and cut operations at Washington's Dulles Airport. To remind himself that passengers will "always migrate to the lower price," Gangwal traded in his fancy gold watch

for the \$14 Timex that he still wears.

Wolf and Gangwal have since shared the ups and downs of their joined-at-the-hip careers. Wolf was forced out of United after an employee buyout in 1994. Gangwal, by then Wolf's top lieutenant, was spared. "His style is not to be as overt as Wolf," says Kevin Lum, head of United's flight attendants' union. "Wolf won't hesitate to tell you that he hates you. Rakesh would at least conduct business with you."

Still, Gangwal and Wolf were too much of a team to split, and Gangwal followed Wolf to Air France. There he revamped the carrier's schedule, cut routes, and implemented a hub system. That was the easy part; getting the carrier's 28 bickering unions to go along took more doing. But he eventually won them over by assigning employee task forces the job of implementing his big plans. By letting employees work out the details, Gangwal made them feel they were part of the decision-making process even as he pushed through his own agenda. He acted "with a lot of authority," says Patrice Durand, chief financial officer at Air France. "But he was careful not to brutalize people."

"MY WAY." These days, Gangwal is still calling the shots. With the exception of Wolf, he consults no one, not even his top managers. And even Wolf has minimal input on Gangwal's daily decisions. "He's very demanding. He can border at times on being unreasonable," Ekey says. But having helped save three struggling airlines, Gangwal offers no apologies. "You're darn right it's my way, because we're trying to get something done," he says.

That remains true today, despite US Airways' much improved health. Like all carriers, it has benefited mightily from high prices and the strong economy. But it is still struggling with its pilots' union over countless grievances and has been fighting an uphill battle for access to some of Europe's key cities. For Gangwal, to fully succeed in remaking US Airways into a strong global competitor, the man who hates to kill time talking will have to make his carefully chosen words count like never before.

By Lorraine Woellert in Washington with David Leonhardt in Chicago

RAKESH GANGWAL

BORN 1953, Calcutta.

EDUCATION B.S., 1975, India Institute of Technology. M.B.A., 1979, Wharton School, University of Pennsylvania.

MOST IMPORTANT

MENTOR Steve Wolf, who became United Airline's CEO in 1987. The pair has remained a close team ever since.

MOST EMBARRASSING

MOMENT While at Air France, being publicly taken to task by the French government for his inability to speak French.

CURRENTLY LOSES

SLEEP OVER US Airways' new \$4 billion, mind-numbingly complex computer-reservation system, set to come on line in November.

BUSINESS PHILOSOPHY

"Life for me is about learning, touching, reading minds, understanding dynamics. You can't boil it down to a number."

FAMILY Wife, Shobha, and daughter, Parul, 9.

SECRET PASSION Buying Beanie Babies for his daughter.

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**Do you
know ?**



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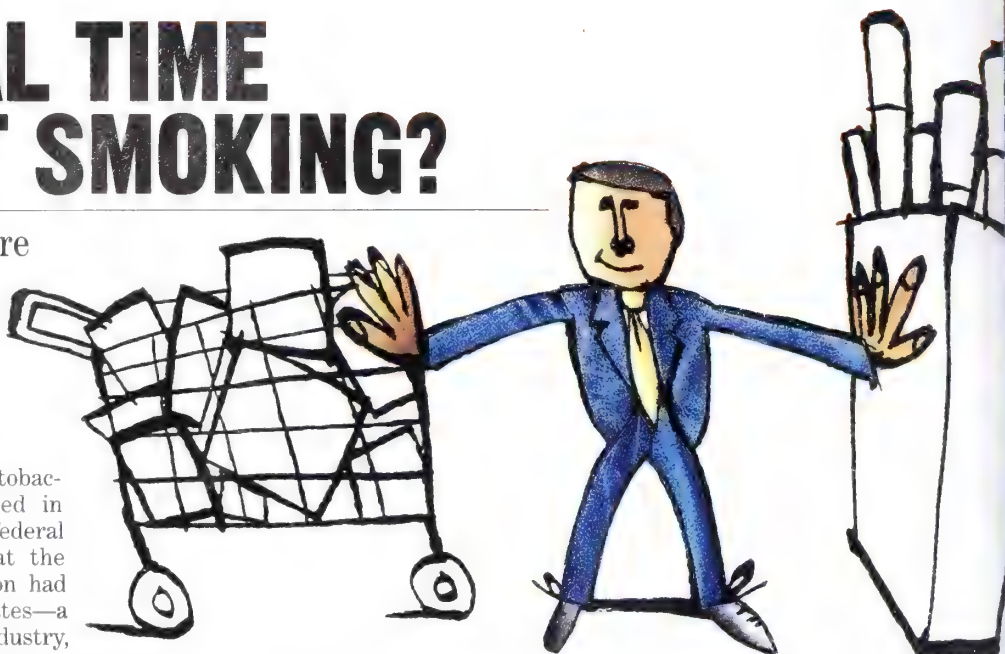
AN IDEAL TIME TO QUIT SMOKING?

After years of pressure from investors, big companies may be ready to spin off their tobacco units

It was the best news the tobacco industry had received in months. On Aug. 14, a federal appeals court ruled that the Food & Drug Administration had no power to regulate cigarettes—a decision that protects the industry, for the time being, from government bureaucrats meddling in the make-up and marketing of its products.

News of this triumph, however, did little to perk up the companies' long stagnant share prices. Bellwether Philip Morris Co. rose $\frac{1}{8}$ %, to 42%, on the day of the ruling. At a closing price of 41% on Aug. 31, the company's stock trades about 10% below where it did when congressional settlement talks were launched 14 months ago. In fact, notwithstanding a recent string of courtroom victories, tobacco stocks have been in their worst rut in years. Based on 1998 estimated earnings, Philip Morris' price-earnings ratio of 13.1 is a mere 63% of the p-e for the Standard & Poor's 500-stock index. That's up from the 55% relative valuation before the market's late summer dive, but still lower than the stock has traded in five years (chart). Rival RJR Nabisco Holdings Corp. has an even lower relative p-e, 42%.

For tobacco chieftains, it's back to square one. Last year's congressionally brokered settlement of the key suits against the industry was to be the magic formula that would rescue the belea-



guered stocks. But public enmity for the industry was so high that Congress kept increasing the price of peace, ultimately driving the companies to kill the measure themselves. Now that it's clear that Washington isn't giving Big Tobacco litigation protection anytime soon, industry leaders have little choice but to come up with a new grand strategy.

PREMATURE? The cigarette makers' next silver bullet is likely to be the spinning off of their tobacco units from the rest of their companies, according to sources inside and outside of the industry. Such a strategy would, first, free their nontobacco divisions from exposure to huge potential litigation losses.

Spin-offs also would likely increase the value of their tobacco businesses, currently treated as nearly worthless by the market. Because the freestanding cigarette units would have the cash flow to offer high dividends, Salomon Smith Barney analyst Martin Feldman argues investors would pay a higher premium for this income stream than they do now, "hidden" as it is among other revenues. He estimates if Philip Morris spun off its tobacco companies, the value of its pieces

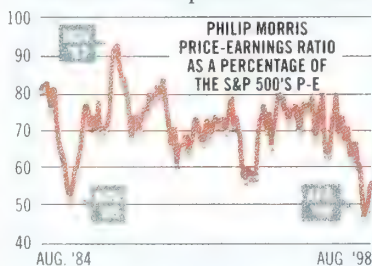
would increase from 41% to about 58. He thinks RJR could climb from 21% to 35%.

Already, Britain's BAT Industries PLC is scheduled to split its tobacco and financial-services businesses on Sept. 8—and an announcement that spin-off plans were on track caused shares to rise 7% in London on Aug. 25. RJR Nabisco would act quickly to spin off its food business if the tobacco companies settle the Medicaid suits brought by a coalition of 37 state attorneys general, says a highly placed RJR executive. Laurence A. Tisch, chairman of Loews Corp., says he "would look at" spinning off subsidiary Lorillard Tobacco Co. from Loews' insurance and hotel units if the state AG cases settle, but he adds that it's premature to consider the issue before then. A Philip Morris spokesperson says the company is not interested in separating its tobacco unit from its Miller beer and Kraft food divisions at this time, though analysts say the company would be under pressure to do so if an RJR spin-off succeeded.

The key to executing the spin-off strategy is hammering out a deal with the states—which may be difficult. Talks began again in New York on Aug. 27, but BAT, RJR, and the state of Massachusetts have dropped out. Although the industry is facing a wide range of legal attacks, the 37 Medicaid suits, seeking hundreds of billions of dollars, are seen as those that could most likely drive the companies into bankruptcy. And as long as there's a chance of insolvency, anti-

GASPING FOR AIR

Now that a deal is dead, the market is placing the lowest value on industry bellwether Philip Morris since 1993



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Because of tobacco's recent winning streak in the courts, executives now think spin-offs may be legally sound

tobacco lawyers could try to block a spin-off by arguing that such a move could prevent clients from collecting if cigarette companies later went bankrupt. Under long-standing principles prohibiting "fraudulent conveyance," companies can't shed assets if there's a chance potential creditors might need them.

Until now, tobacco companies have resisted shareholder pressure for spin-offs by arguing that the overall legal environment was so hostile they had no chance to beat back attacks by plaintiffs' lawyers. But because of the industry's recent winning streak in court, executives now believe they could convince a court that the private lawsuits against them are unlikely to mushroom into a potentially bankrupting threat. On Aug. 13, for example, BAT's Brown & Williamson Tobacco Corp. successfully overturned a \$1 million decision in favor of a Florida smoker—restoring, for now at least, the industry's perfect record against suits brought by individual smokers. Several state and federal courts throughout the country, meanwhile, have blocked class actions against the industry in recent months.

Pointing out that the industry's recent win record is sprinkled with a few key defeats, personal injury lawyers say the companies are exaggerating their success. Nonetheless, Columbia Law School professor John C. Coffee says if the companies and the states can settle, it would be hard for private lawyers to halt any spin-offs.

Still, no restructuring is possible unless Big Tobacco can make the state Medicaid cases go away first. Neither the companies nor the state attorneys general involved in the talks would discuss their negotiations. Despite the fact that some key players have walked out, Sanford C. Bernstein analyst Gary D. Black believes that both sides will eventually work out a deal and attributes the recent turbulence in the peace talks to gamesmanship. Nonetheless, there are some tough issues to resolve. For example, companies want to make sure the increased costs they will shoulder in order to pay the states won't give foreign companies and a handful of tiny domestic competitors an opportunity to grab market share (box).

Even if Big Tobacco settles the state

cases, the White House has in recent days threatened to bring a suit that would aim to recoup hundreds of billions in federal funds spent on treating smokers' illnesses. Such a filing would give any judge pause before allowing tobacco companies to split.

Despite the obstacles, though, spin-offs are probably still the companies' best hope. If they aren't able to shed their tobacco units, manufacturers will be stuck right back in the same litigation nightmare that drove down their share prices in the first place.

*By Mike France and
Larry Light in New York,
with bureau reports*



WHY 'LITTLE TOBACCO' LOOMS LARGER

While America's five leading cigarette makers—Philip Morris, RJR Nabisco, Brown & Williamson Tobacco, Lorillard Tobacco, and Liggett Group—dominate the cigarette market, there are also a few tiny companies in the business. Call them Little Tobacco. S&M Brands in Keysville, Va., for example, sells about \$10 million a year of its Bailey's cigarettes. Other players include Santa Fe Natural Tobacco Co. in Santa Fe, N.M., maker of Natural American Spirit, and Commonwealth Brands in Bowling Green, Ky., which produces Montclair and Malibu cigarettes.

These companies aren't at the bargaining table with state attorneys general—their combined market share is less than 2%—but they have emerged as a potential stumbling block to a settlement of state Medicaid suits. Free of the billions of dollars' worth of extra costs the deal

would impose, not to mention tight new marketing restrictions, Little Tobacco could suddenly be in a position to grab market share. That prospect recently drove RJR and B&W, which depend heavily on the discount market, from the bargaining table when no mechanism for dealing with the problem could immediately be found. Large foreigners such as Japan Tobacco, France's SEITA, and Britain's Gallaher could also muscle their way into the U.S. No competitive advantage would have existed had a congressional settlement passed, since it would have applied to all cigarette makers selling in the U.S.

LOOPHOLE. The deal that state attorneys general and major cigarette makers are mulling would cost about \$200 billion over 25 years. That translates into about a 35¢-per-pack hike in Big Tobacco's costs, according to Sanford C. Bernstein analyst Gary D. Black. The industry fears that any

company not a signatory to the deal could use this margin to lower prices. "The bottom line is that we don't want to create a loophole for someone to enter the market and not have to bear responsibility for the health issues," says an industry spokesperson.

Steven Bailey, S&M Brands executive vice-president, says the major U.S. tobacco companies exaggerate the threat presented by Little Tobacco. Big makers spend billions building their brands and subsidizing wholesalers and retailers, he notes, so it's all but impossible for smaller players to win new market share. But with U.S. cigarette sales declining overall, don't expect Big Tobacco to let Bailey and his ilk gain much new ground.

By Mike France in New York

NATHAN MYHRVOLD, CHIEF TECHNOLOGY OFFICER, MICROSOFT CORPORATION, CHOSE THE GULFSTREAM V AS THE TECHNICALLY SUPERIOR AIRPLANE.



WHY THIS BRILLIANT TECHNICAL FUTURIST BOUGHT THE 100TH GULFSTREAM V.

Nathan Myhrvold is Bill Gates' chief scientist and widely regarded as perhaps the most influential technical mind of ir time.

He is a postdoctoral fellow in applied mathematics and theoretical physics at Cambridge University. He has a Ph.D. in theoretical mathematics and physics, as well as an M.S. in mathematical economics from Princeton University. He has both an M.S. in geophysics and space physics and a B.S. in mathematics from the University of California.

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WHAT'VE YOU DONE FOR US LATELY?

Data mining is pinpointing which customers are profitable

Like most companies, Federal Express Corp. has some customers that are losers: The cost of doing business with them is greater than the profits they return to the shipper. But FedEx has an edge that most companies lack—it knows who those customers are. That knowledge has kicked off a marketing revolution inside FedEx, where customers sometimes are rated as the good, the bad, and the ugly. “We want to keep the good, grow the bad, and the ugly we want nothing to do with,” says Sharanjit Singh, managing director for marketing analysis at FedEx.

It's relatively easy for companies to recognize who is spending money with them. But surprisingly, identifying which customers are profitable for them requires a quantum leap in sophistication. Confounded by technical difficulties and the high cost of software and data storage, many businesses muddle along with only a rough approximation of which customers make them money. “Not too many people have actually done this yet because it's difficult to pull off,” says Wayne Eckerson, a principal analyst at Data Warehouse Institute.

But those few that have begun are finding that determining each customer's profitability can pay big dividends. Savvy companies are conducting behind-the-scenes beauty contests to determine who they like and who they wish would go away. Companies such as U S West, Bank of America, and The Limited are creating vast information warehouses stocked with customer data that allow them to compare the complex

mix of marketing and servicing costs that go into retaining each individual consumer, vs. the revenues he or she is likely to bring in. “Some companies are building a profit-and-loss statement for each customer,” says Mike Caccavale, president of Aperio Inc., a consulting firm that specializes in customer-relationship management.

Of course, companies have been using large databases to help refine their mar-

LOOKING OUT FOR NO. 1
Once lucrative customers are identified, marketers can be alert for signs that they may bolt—and head them off with a phone call



keting efforts for years. But previous attempts focused on the average behavior of large demographic groups, while the newer efforts allow marketers to target individual customers with pinpoint accuracy. And the latest techniques go well beyond determining whether a marketing campaign encourages a consumer to buy—they focus on whether or not that consumer spends enough to make a campaign worthwhile.

At FedEx, customers who spend a lot with little service and marketing investment get different treatment than, say, those who spend just as much but cost more to keep. The “good” can expect a phone call if their shipping volume falters, which can head off defections before they occur. As for the “bad”—those who spend but are expensive to the company—FedEx is turning them into profitable customers, in many cases, by charging higher shipping prices. And the “ugly”? Those customers who spend little and show few signs of spending more in the future? They can catch the TV ads. “We just don't market to them anymore,” says Singh. “That automatically brings our costs down.”

The power of such an approach lies in a company's ability to determine how much to spend on marketing campaigns—and where to direct those dollars. Twice a year, U S West sifts through its customer list looking for money-losers who have the potential to be more profitable in the future. The starting point is a database containing as many as 200 observations about each customer's calling patterns. By looking at demographic profiles, plus the mix of local vs. long-distance calls, or whether a customer has voice mail, they can estimate a customer's potential telecom spending.

Next, U S West determines how much of the customer's likely telecom budget is already coming its way. Armed with that knowledge, “we can set a cutoff point for how much to spend marketing to this customer before it begins to deteriorate our profitability,” says Dennis J. DeGregor, chief database mar-

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keting executive for U S West. Those savings fall straight to the bottom line.

Seems like the kind of information marketers would die for. But so far, only a handful have taken the plunge. For one thing, it's expensive. Fleet

Bank, one of the few big companies to break out its costs, is spending \$38 million just to get started. Also, details about which customers are profitable and which aren't is not always welcome news. "It means the things you did in the past were wrong," says Scott Nelson, an analyst at Gartner Group. "Big advertising campaigns, product introductions—all might be mistakes because you find out they didn't contribute profit."

WRONG REVENUES. That's what executives at Glasgow-based Standard Life Assurance, Europe's largest mutual life-insurance company, discovered earlier this year. They were stunned when the first cut of a profitability survey showed that the insurer was loading up fast on policyholders who held little or no potential for making money. Instead of bringing in the affluent customers Stan-

dard Life wanted, its direct-mail marketing campaign was encouraging elderly couples and stay-at-home mothers to sign up for costly home visits by sales agents. Revenues were up—but they were the wrong kind of revenues. "It

mining for profitable customers a tough task. The mechanics are demanding. To get a true picture of customer profitability, Bank of America calculates its profits every month on each of its more than 75 million accounts. Mortgages, for

instance, have different costs than checking accounts, car loans, or home-equity credit accounts. And service costs vary by how customers bank—whether they use ATMs, tellers, or the Net.

By wading through all that data, however, BofA is able to zero in on the 10% of households that are most profitable. It assigns a financial adviser to track about 300 accounts at a time. Their job: to answer questions, coordinate the bank's efforts to sell more services, and—perhaps most important—watch for warning flags that these lucrative customers may be moving their

business elsewhere.

If the bank's computer notes a change in the customer's normal pattern of transactions or a falling balance, for example, it alerts the account manager, who may post a flag to the tellers at the customer's branch warning that the

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- ▶ You're getting fewer catalogs: You may have been blacklisted. As a low-spender, you're not worth the company's marketing dollars.

was an exact mismatch," says Graham Wilson, Standard's database and statistics manager. "These are people who love to sit down and have a cup of tea with someone, but they typically buy only one policy, and margins are small."

Even motivated companies may find

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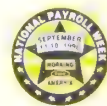
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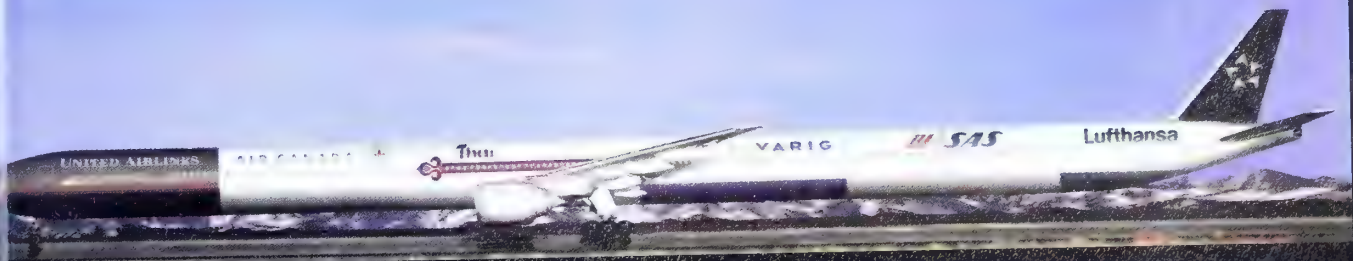
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account is in danger of moving.

The next time the customer walks into the bank, a teller asks if they have any concerns about the account and offer them a chat with the bank manager. The heavy intervention seems to be working. Since BofA launched the program 18 months ago, customer defections are down, and account balances in the top 10% have grown measurably. "When such a small percentage of customers generate such a large percentage of profits, this kind of program is critical," says Christopher Kelly, senior vice-president for database marketing at Bank of America. "We view it as a strategic weapon."

HANDHOLDING. Often, the strategy is used not to jettison low-spending customers or to reward the cream of the crop. Efforts are focused on those in the middle—customers who aren't yet profitable but whose demographics suggest that they could be. Consider Joseph Taylor, a 62-year-old minister in the United Church of Christ and a professor of pastoral theology at Howard University in Washington. When First Union Bank bought Signet Bank in 1997, Taylor's accounts moved, too. As First Union combed through Signet's records

looking for customers with higher profit potential, up popped Taylor. Soon, a marketing push to profitability began.

First Union's buyout of Signet was the third time Taylor's bank had been acquired, and he was fed up. But he dropped his plans to switch when he received a phone call from a First Union marketer. "He talked as if he had

Often, efforts focus on prodding customers who aren't quite profitable but could be

known me, even though we had never met," Taylor says. Taylor maintained high balances in his bank accounts, frequently writing large checks to help church members in need. The marketer suggested that Taylor consolidate his checking and savings accounts in one interest-bearing account, providing income to Taylor while reducing the bank's servicing costs. First Union also persuaded Taylor to sign up for a home-

equity loan, and he brought over the accounts from his ministry as well.

Customers who cost more to lure than they're worth aren't likely to see the same pampering. For those who enjoy browsing through catalogs without buying much, the days of receiving free reading material may be numbered. Mail-order retailers such as Victoria's Secret are winnowing their lists to focus on the most profitable recipients. "Some we expect to drop—those we don't get any return from at all," says Frank Giannantonio, chief information officer for Victoria's Secret.

"Free money" offers are already on the wane. MCI Communications, Sprint and AT&T have largely dropped their once-omnipresent offers of cash for customers who switch their long-distance service. "They were offering \$20, \$30, \$50 to all takers, without any understanding about whether they actually would want to retain those customers once they had won them," says Thomas Tague, chief operations officer for Tessera Enterprise Systems Inc., a data-warehouse builder. Now, focusing on profitability gives the phrase "valued customer" a whole new twist.

By Paul C. Judge, in Boston

A better exchange rate.



What's Your Global Priority? <---

1B09

* Price comparisons based on published prices for flat-rate envelopes for countries serviced by Global Priority Mail (excluding Canada & Mexico). Global Priority Mail up to 4 lbs. \$6.95 and \$2.15 (Pacific Rim & South America) vs. FedEx International Priority® up to 8 oz. from \$25.50 to \$65 and UPS® Worldwide Express (letter) from \$27.50 to \$40.75. ©1998 U.S. Postal Service

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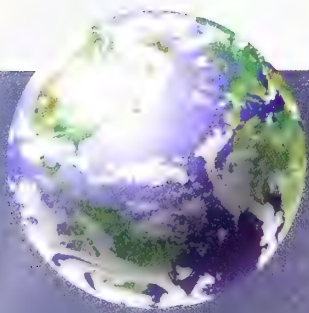


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STILL THE PARTY OF BIG BUSINESS?

The clash between GOP merchants and moralists is taking a heavy toll

The chief business of the American people is business.

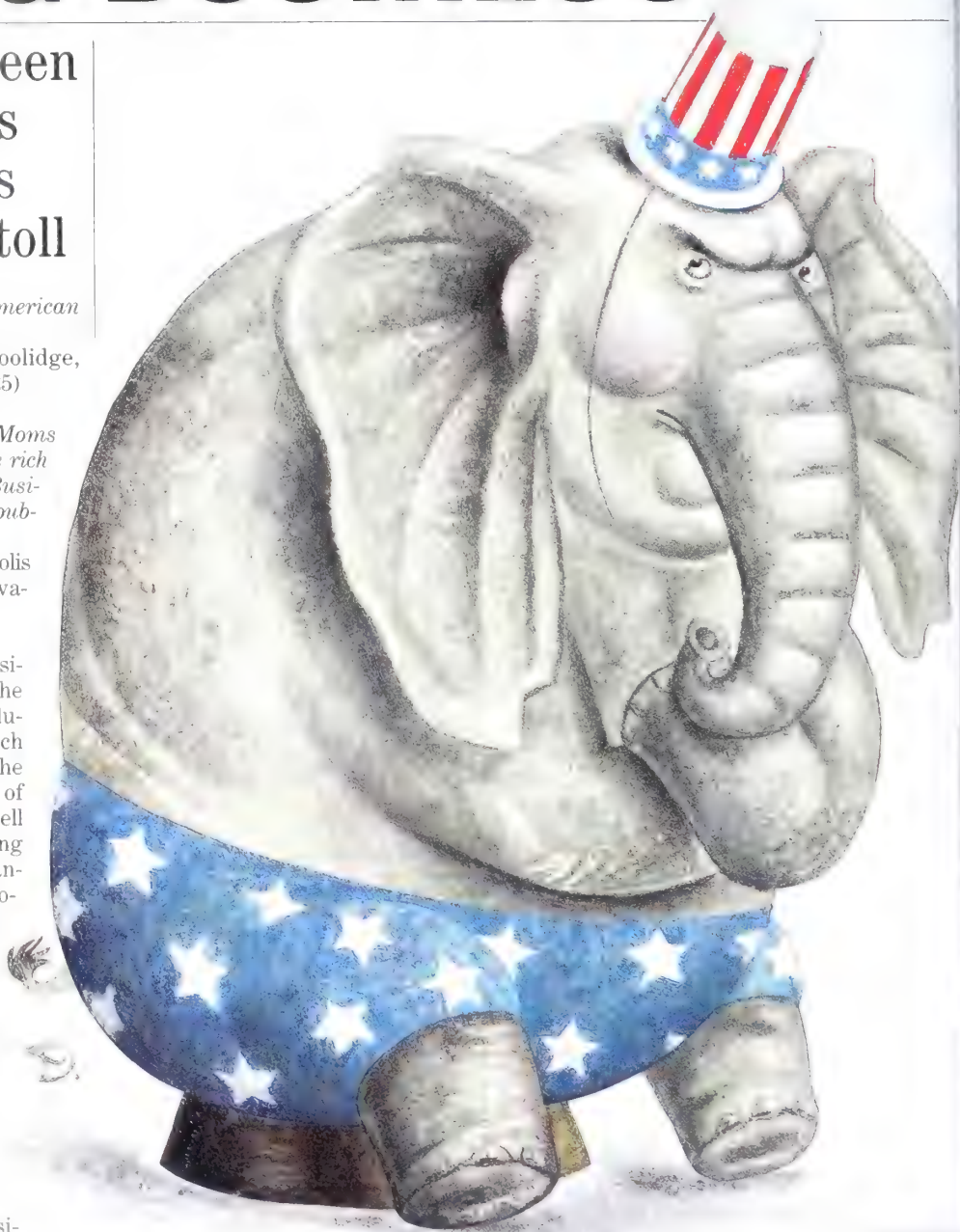
—Attributed to Calvin Coolidge, 30th President of the U.S. (1925)

Republicans' allies are the Moms and Pops, the entrepreneurs. The rich are not.... [That's why] Big Business can no longer trust the Republican Party—and vice versa.

—J. Patrick Rooney, Indianapolis insurance executive and conservative activist (1998)

Most days in America, business is conducted on the manicured turf of exclusive country clubs much as it was in Silent Cal's day. The titans of industry and masters of the money universe now have cell phones in their golf bags—along with \$600 drivers. But the ancient ritual of stroking and socializing goes on as the seeds of tomorrow's deals are planted amid languid strolls on the links.

But there is one place where this quaint world of clubby Republicanism has changed big-time: Capitol Hill. Ask one of the new social conservatives about Corporate America's clout, and you're likely to get a lecture about Big Business' misguided priorities—from replenishing the International Monetary Fund, to expanding trade with China,



setting national performance goals for America's struggling schools.

Quiz Republican Hill leaders about their archetypal business exec, and you'll never get a mention of Jack Welch of General Electric or Sandy Weill of Travelers Group. Instead, you'll hear about folks like Ernie George, a feisty grandmother who heads Ridewinder Pumps, a six-employee outfit that builds chemical pumps in Lafayette, La.

George goes to church every Sunday, teaches Bible classes, and gets regular mailings from the Christian Coalition. And instead of belonging to

an old-line business lobby like the U.S. Chamber of Commerce, she is a member of the more militant National Federation of Independent Business (NFIB). She could care less about the IMF. Her concerns are doing away with estate taxes, protection from product-liability suits, and fending off government regulators.

While most big-company CEOs steer clear of social issues, George wants to sanction school prayer and kill the secularist Education Dept. And she wants Capitol Hill Republicans to be more radical, not less. "They look like they're afraid of the Democrats," she complains.

Increasingly, entrepreneurs like George are holding sway in a new, more intensely ideological Republican Party—one that reviles Big Business pragmatism and considers CEOs corporate Quislings. So where is the Boardroom Set supposed to turn? Many execs have been pleasantly surprised by the Clinton Administration's fiscal restraint and pro-export tilt. But the Monica Lewinsky scandal has rendered the one-time Salesman-

in-Chief *hors de combat* just as global markets are swooning.

Thomas J. Donohue, president of the U.S. Chamber of Commerce, has vowed that Corporate America will support those candidates who help promote a pro-business climate—no matter what their party affiliation. But while Big Business can point to a growing cadre of New Democrats that shares its economic goals, the day when the Democratic Party can be considered an ally is many elections away. House Minority Leader Dick Gephardt of Missouri and other leaders of the Hill Democrats remain in thrall to Big Labor and liberal interest groups.

"BUNCH OF RUBES." Executives who instinctively turn to Republicans for help have been caught off balance by the GOP's shift. "Used to be, if you were a corporate guy, you could fly to Pebble Beach with the chairman of the House Ways & Means Committee, play some golf, and get things taken care of," says Dan Danner, the NFIB's top lobbyist. "That's changed. Congress has become more populist. Corporations are having a difficult time figuring out how to deal with that."

The Republican tilt toward folks like Ernie George isn't new, but it's accelerating. That's partly a reflection of the party's growing base in the South and West, where hostility to Washington runs deep. Anticorporate, antiglobalist populism has also blossomed as the GOP has expanded to include millions of religious fundamentalists and culturally conservative blue-collar workers.

"Deep down, a lot of business leaders think these Religious Right guys are a bunch of rubes," says Georgetown University political scientist Clyde Wilcox. "That's a mistake. They might wake up one day and discover they've lost control of their party."

To some, that day seems in sight. Conservatives are festooning trade bills with human rights requirements, despite business objections. GOP tax policy focuses on "pro-family" breaks sought by religious activists, at the expense of corporate tax relief. And Religious Righters have linked an \$18 billion IMF bailout to a ban on late-term abortion. Meanwhile, the global econom-



With the Republican Party co-opted by religious conservatives, populists, and anti-globalists, Corporate America isn't getting much bang for its bucks

ic malaise deepens. "Businesspeople don't understand what abortion has to do with job creation," says Representative Amo Houghton (R-N.Y.), former CEO of Corning.

It's not just international policies that are under attack. On July 10, religious activists struck a blow against Walt Disney Co. when a Texas Board of Education dominated by the Religious Right voted to divest \$43 million in company stock. Disney's sins: offering "domestic partner" benefits to gay employees and promoting sex and violence in some of its films. Conservative crusaders are urging other school boards and pension funds to follow suit.

GODSPEED. Most CEOs are economic conservatives. Still, many are troubled by the mixture of moralizing and commerce. "I talked recently to a prominent Republican in my district who has reregistered as an independent," says House Republican Tom Campbell, who represents Silicon Valley. "He was driven away by the dominance of conservative social issues over economic issues. I've got other friends in the venture-capital community who have bolted."

Bolt away, reply religious activists. Crusaders such as Gary L. Bauer, president of the Family Research Council and a possible 2000 Presidential candidate, feel that a purifying break from the country-club elites may be just what the GOP needs (page 160). "I don't think there's any doubt," Bauer charges, "that some corporations have put profits in front of virtually everything else"—patriotism included.

Case in point: U.S. multinationals' rush into China. Organizations such as Bauer's are teaming up with unions and liberal human rights groups trying to slap trade restrictions on Beijing. Exporters feel the sanctions are futile gestures that will cost the U.S. jobs.

Many new Republicans are repulsed by the pragmatism of Big Business. Rather than fighting for conservative principles, they charge, CEOs are quick to compromise with Democrats—and, worse, write fat checks to Democratic in-

cumbents. "Big Business doesn't have a party," scoffs Michele Davis, a top aide to House Majority Leader Richard K. Armey (R-Tex.).

House Speaker Newt Gingrich (R-Ga.), for one, is livid over corporate political giving. Although business committees sharply shifted donations to the GOP after the 1994 Republican takeover of Congress, he is furious that they continue to contribute to the opposition. "Business is being ill-served by its K Street lobbyists, many of whom are former Democratic staffers," says

Grover G. Norquist, a Gingrich adviser who heads Americans for Tax Reform. "They hate the Republican leadership and don't like all those Christians running around the Capitol."

Certainly, old-line lobbies such as the National Association of Manufacturers and the Business Roundtable are feeling a distinct chill these days from GOP populists. A leading scourge: House Budget Committee Chairman John R. Kasich (R-Ohio), who delights in putting Big Business' pet programs on his "corporate welfare" hit list. Says GOP consul-

tant Ed Gillespie: "Republicans are much quicker to return phone calls from the NFIB or the Christian Coalition than the Roundtable."

That's why the tension will crackle on Sept. 16, when Gingrich is set to address a Washington meeting of the Roundtable. He wants companies to stop whining and cough up the \$37 million he has budgeted for a new crusade: an issue-advocacy campaign designed to counter an AFL-CIO offensive this fall. Well in advance of the session, the word is out that executives can expect a cold shoulder in '99 if they don't dig deep.

SLUGFEST. Hostilities broke into the open this summer when the Republican leadership found itself in a slugfest with the Business-Industry Political Action Committee (BIPAC), one of the business community's oldest political arms. Upset that some Republican legislators opposed measures such as IMF funding and fast-track, trade-negotiating authority, the PAC's leaders suggested that the GOP could no longer be counted on to deliver business' agenda. Says BIPAC President Charles S. Mack: "I know of some PAC managers who have already told [GOP] candidates, 'Sorry, not this year.'"

Hard-liners demanded the ouster of BIPAC Vice-President Bernadette Budde, who co-authored the memo. But the apostates also include R. Bruce Josten, top lobbyist of the U.S. Chamber. A man with impeccable conservative credentials, Josten blasted the GOP's "isolationism" and flag-

FLASH POINTS IN THE STRUGGLE FOR CONTROL OF THE GOP

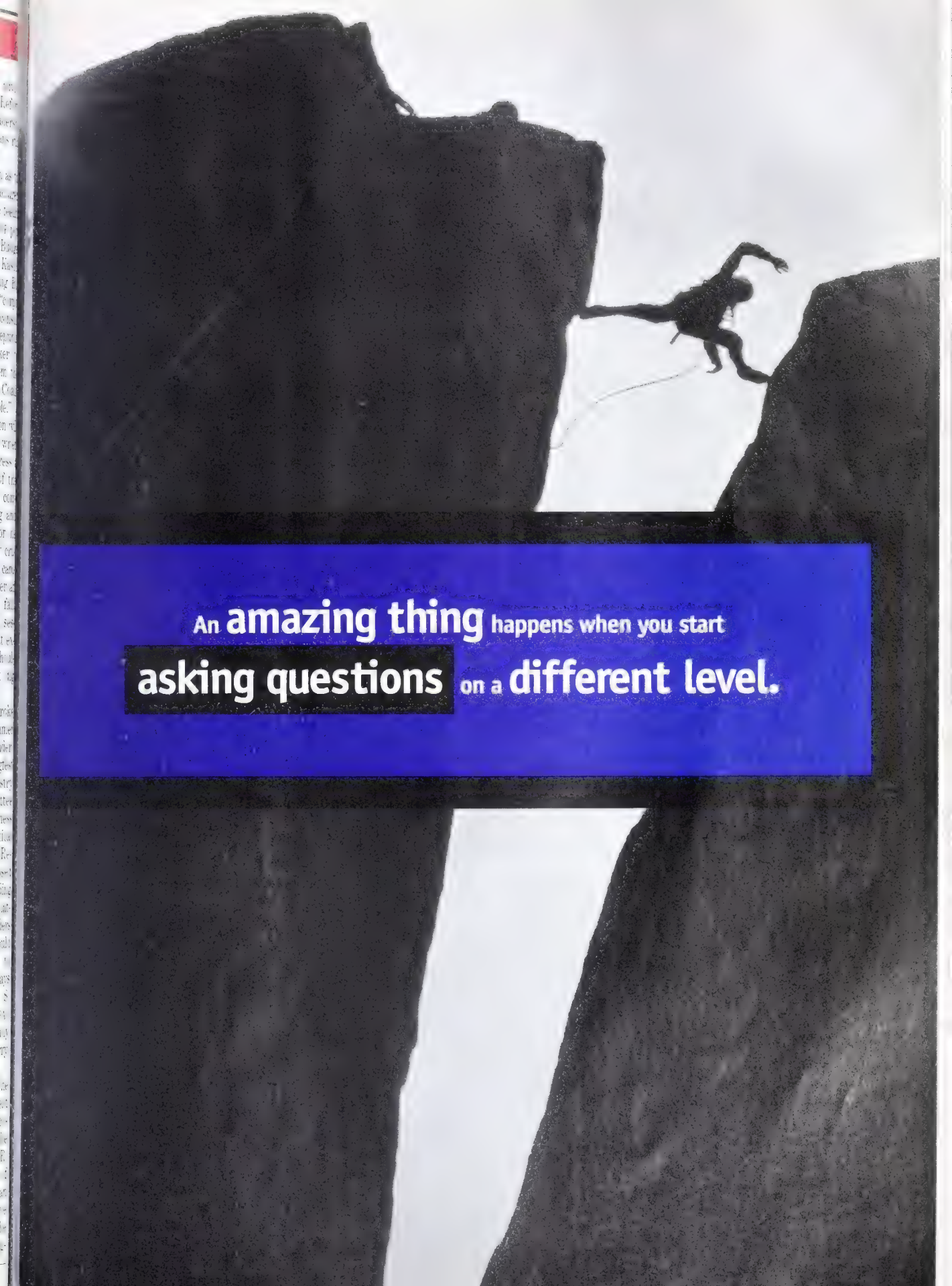
Big Business has gotten two very unpleasant surprises from its allies in the past year



IMF With Russian and Asian economies tanking, Corporate America is eager for an \$18 billion IMF infusion. Social conservatives, however, are concerned about crony capitalism and have linked the plan to abortion restrictions. Status: On hold



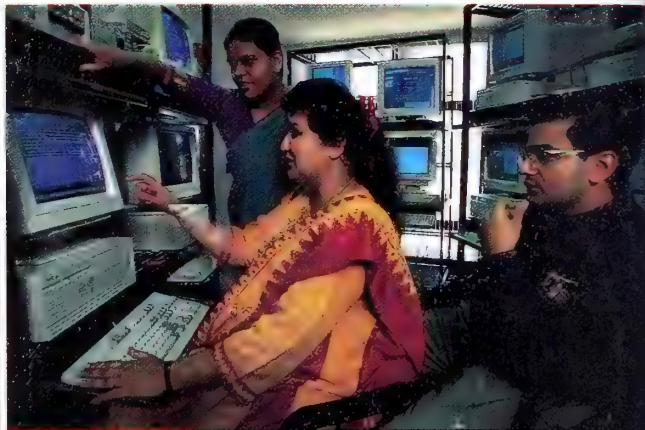
FAST TRACK Giving Clinton the authority to negotiate fast-track trade deals would have expanded commerce with Latin America, but anti-NAFTA Democrats and maverick Republicans put passage in doubt. Status: On hold



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asking questions on a **different level.**



TAX POLICY *The boardroom gang wants more capital-gains cuts and liberalized write-offs for plant and equipment. Social conservatives, on the other hand, are focused on cutting the marriage penalty by \$70 billion.*



IMMIGRATION *Republican populists are out to restrict quotas and benefits for legal immigrants. That worries the high-tech biz, which doesn't want to slow the flow of engineers and software developers from places like India.*

ging attention to business issues.

Fearing an open rupture, GOP leaders in June opted for what was dubbed the Treaty of K Street. They met with chief executives and lobbyists and agreed to halt the public squabbling. Gingrich followed up by announcing support for a capital-gains tax cut and liberalized immigration quotas for high-tech workers. And he pledged to push for a vote on a bill that gives the IMF \$3.4 billion in short-term cash.

But few of the combatants think the conflict is over. Coming in the waning days of a congressional session, sniffs one business lobbyist, the gestures seem hollow. Many wonder whether Gingrich can deliver on his pledge of IMF money. Conservatives aren't mollified, either. "They're trying to paper it over and say we all want to cut taxes," says Kevin Kearns, president of the U.S. Business & Industrial Council, a coalition of small and midsize companies.

While GOP leaders try to downplay the split, skirmishes between Big Business and social conservatives continue. Among the fundamental differences:

■ **Globalism.** Of all the shifts in the Republican coalition, the one that disturbs CEOs most is the party's drift away from enthusiastic support of free trade. They were shaken by last year's defeat of the Administration's fast-track bill, which saw the defection of a small but significant group of Republicans. Despite support from GOP leaders, populists balked because fast-track would bar Congress from amending trade deals—thereby denying social conservatives

the option of adding anti-abortion and religious-rights requirements. Gingrich now favors a late-session vote on fast-track, but many execs think it's mainly a ploy to divide Democrats and embarrass Clinton.

On issues such as trade and the IMF, social activists are hanging tough. They want restrictions on international family planning before they will provide cash for the fund, while others demand reforms to make the international lending agency more accountable. "It's unfair to say social conservatives are antitrade," says Senator John D. Ashcroft (R-Mo.), a Christian Coalition favorite in early jockeying for the 2000 GOP Presidential nomination. "They're not for trade at any price."

Exporters counter that by failing to shore up the IMF, the GOP heightens the risk that the Russian and Asian crises could wreck the U.S. economy. "We've got bleeding patients in the emergency room, and we're debating procedures," snaps William J. Hudson, CEO of AMP

Inc., a Harrisburg (Pa.) manufacturer of electronic connectors.

On economic engagement with China even the Religious Right is split. Christian Coalition founder Pat Robertson, who has business ties in China, favors expanded trade. Bauer and religious broadcaster James C. Dobson, head of the powerful Focus on the Family group, oppose it and back legislation that would penalize Beijing and other regimes that persecute religious minorities. "Republicans ought to be the party of business," says consultant Ralph Reed, former executive director of the Christian Coalition. "But the Coalition is now being spread over barbed wire by other social conservatives for its pro-China trade stance."

One CEO firmly in the China camp is Amway's Dick DeVos—though that's no surprise given the millions he has bet on Beijing. "We want economic and political freedom in China," he says. "It's not a question of strategy, but of tactics. I prefer to focus on the issues and not at-

tempt to attach extraneous riders" to China trade bills. C. William Zadell, CEO of Millipore Corp., a Bedford (Mass.) filter maker that has just opened a manufacturing plant in China, is just as adamant. "When Republicans ran the Administration, Democrats harped on human rights," he



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DIVERSITY

Most big corporations like Disney have well-defined diversity and affirmative-action programs in place, so they find the conservative call to end special breaks for minorities and women disruptive.

says. "Now the Religious Right is doing it. We'd make a giant mistake if we start putting sanctions on our business with China."

■ **Social Issues.** While some executives sympathize with conservative social crusades, others find them disruptive. The campaign to end affirmative-action preferences is a good example. Big-company CEOs are comfortable with the current system, which sets goals and timetables for the hiring and promotion of women and minorities. But the commitment to diversity clashes with social activists' demands for a "color-blind society." Conservatives led the fight for a 1997 California ballot initiative that ended state affirmative-action programs and want to take the battle nationwide. They're furious that business isn't backing them.

Immigration is another hot-button topic. Hill populists want to restrict quotas and reduce benefits for legal immigrants. High-tech industries worry that the drive will cut off the flow of engineers and software developers. They want Congress to grant a waiver for highly skilled workers.

Big Business and social crusaders also clash over education. The latter faction considers the President's plan to spend more on schools and set national education goals a Big Government abomination. But even execs who admire the GOP's call for school vouchers fear that greater choice alone won't produce the workforce of the future.

■ **Tax Policy.** Business execs hate the Internal Revenue Service just as much as GOP hard-

liners—if not more so. Still, they differ over which tax policy makes the most economic sense. Concerned about boosting savings and investment, the boardroom crowd favors cuts in capital-gains taxes, liberalized write-offs for plant and equipment, and lower marginal rates.

But often the Republican majority seems to be more interested in mollifying the Religious Right than in listening to economic conservatives. Hill Republicans pay lip service to a "fairer, flatter" tax code while their energy is focused on a drive to cut the "marriage penalty" by \$70 billion. And GOP lawmakers continue to champion a grab bag of "equity" tax breaks favored by religious conservatives—such as deductions for stay-at-home moms and a new tax-sheltered account for private and religious education.

"Republicans are betwixt and between," says former White House Chief of Staff Leon E. Panetta. "They're trying to decide whether their voting base is more important than their business-money base."



RELIGIOUS PERSECUTION

Even the Right is split over how to deal with allegations of religious persecution in countries like China. Corporate America sees the flap as a weakening in the Republican commitment to expanded trade.

Indeed, the conflict between traditional Northeastern Republicans and Sunbelt populists predates the current dustup. In the Fifties, a rising politician named Richard M. Nixon spoke for a new generation of Western Republicans who blasted the Eastern Establishment. In 1964, Barry Goldwater routed the Rockefeller Republicans by harnessing rank-and-file hatred of Big Government and Communism. But Goldwater was a libertarian when it came to social issues, opposing federal intervention both in the boardroom and the bedroom.

■ **SOUTHERN STRATEGY.** A turning point came in 1980, when Ronald Reagan expanded the party base by attracting millions of blue-collar workers and conservative Christians, many of them from the South. The demographic shift accelerated in recent years with the collapse of the Democratic Party in many Southern states.

Before Goldwater, about two-thirds of Republicans lived north of the Mason-Dixon line and east of the Mississippi, estimates GOP pollster Christine Matthews. Now, only one-third do. That has led to a more polarizing ideological stance. "Republicans have lost a lot of [House] seats in the Northeast, which is traditionally for free trade," says Matthews. "They've picked

OPEN MIND AND WALLET

Chamber of Commerce chief Donohue claims he will back pro-business candidates, whatever their party affiliation



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them up in the South, which has tended to be more protectionist and anticorporate."

New-wave conservatives are comfortable knocking Big Business because their list of grievances is so long. They slam corporats for perpetuating Big Government by lobbying to protect subsidies and other forms of federal largesse. Complains Representative John Linder (R-Ga.), chairman of the National Republican Congressional Committee: "Entrepreneurs are truly free-marketters. Corporate America wants the government to help out."

Hard-liners also fault their pin-striped brethren for failing to mobilize employees. CEOs excel at hiring pricey Washington reps to push pet causes, they charge. But when conservatives need to stoke opposition to, say, a boost in the minimum wage, the boardroom brigade is often AWOL. "Pro-family groups are very good at providing foot soldiers," notes a top Republican aide on Capitol Hill. "They show up with 300 volunteers to put up yard signs. I don't see too many executives out there on a Saturday afternoon going door to door."

Social conservatives' new muscle was evident this spring, when Focus on the Family chief Dobson threatened to bolt the GOP unless more heed was paid to moral issues. In a whirlwind tour of the Capitol, he got the red-carpet treatment from House leaders—and new pledges to stick to the pro-family script.

PICKING TARGETS. Now, there are signs that Big Business may be learning a lesson from the Religious Right's rise. One tactic is borrowed directly from the Christian Right's hymnbook: grassroots organizing. In June, the Business Roundtable began a major education campaign to stoke public support for free trade. The effort, which initially will focus on 12 congressional districts, involves television ads, educational speeches by CEOs, and meetings with local politicians and opinion leaders.

Other groups are expected to follow suit by airing more advocacy advertising. By concentrating on specific issues, business can control the message and guarantee that its money will not end up in the



hands of candidates who oppose its priorities.

There are also hints that corporations may be tightening the screws on renegades. The share of business PAC money going to GOP congressional candidates dipped from 70% in 1995-96 to 63.4% as of June, 1998, according to the non-partisan Center for Responsive Politics. "We keep track of votes and have six to eight key issues on which we rank possible recipients of PAC money before we make a judgment," says the lobbyist for a big high-tech company.

Procter & Gamble Co. also seems ready to play hardball. In what was seen as a threat to donations, P&G lobbyists have pointedly complained to at least one Republican lawmaker—Ohio Representative Robert W. Ney—about his opposition to granting China fa-

vored trading status.

"Some Republicans aren't going to be there on trade issues," notes Dan Schnur, a California GOP consultant who advises high-tech outfits. "Ultimately, business is going to form relationships with elements of both parties."

That's precisely what is happening. On business and trade issues, industry turns to Republican pragmatists such as Representatives Christopher Cox (Calif.) and Rick White (Wash.), along with Senators Spencer Abraham of Michigan and Chuck Hagel of Nebraska. And execs work well with Democratic moderates such as California Representatives Ellen O. Tauscher, Cal Dooley,

and Zoe Lofgren. Democratic Senator Jeff Bingaman of New Mexico is a techie crusader. And Corporate America counts on pro-business Democratic centrists such as Senators Joseph I. Lieberman of Connecticut and John B. Breaux of Louisiana. **STUCK IN TIME.** For all their coalition-building, though, execs continue to turn principally to Republicans to advance their agenda. Although it's been swell up to now, Bill Clinton's scandal-plagued reign can't be relied on to advance the pro-business cause with much vigor any longer. And while there are exceptions, top congressional Dems still seem ideologically stuck in Clinton's student radical days. The upshot is that on concerns such as slashing red tape, limiting the size of government, and pushing for legal reform, the GOP—shrill and unruly though it may be—is still the only game in town for Big Business.

Ultimately, the tug-of-war between the GOP's small-town moralists and its uptown merchants could come to a showdown in the 2000 Presidential primaries. Social conservatives are demanding that nominees embrace an agenda that includes abortion curbs, school prayer, and the "de-funding" of hated agencies such as the National Endowment for the Arts.

But such absolutism would

FRIENDS OF BUSINESS

Democrats like President Clinton and Representative Tauscher are often able to find common ground with Big Business





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marginalize many of the party's best-known national figures, among them retired General Colin Powell, New Jersey Governor Christine Todd Whitman, and New York Governor George Pataki. And it could pose a threat to the presumed candidacy of Texas Governor George W. Bush, a Big Business favorite in the 2000 sweepstakes. "If we have a party that's

defined as moralist, we'll never be a majority party," frets Mike Johnson, a founder of the Republican Main Street Partnership.

The stakes for Corporate America in this brawl inside the GOP big tent could not be higher. With both parties' commitment to free trade in doubt and global economic crises mushrooming, busi-

ness needs a Washington that works. Instead, corporate executives are forced to watch the gory spectacle of the Roundheads vs. the Roundtable. It is a battle in which, they fear, there are no winners.

By Richard S. Dunham and Am Borrus, with Lee Walczak, in Washington, and bureau reports

RUMBLE ON THE RIGHT: A TALK WITH GARY BAUER

Gary L. Bauer, head of the Family Research Council and possible Republican Presidential aspirant in 2000, is the sort of unabashed social conservative who gives Corporate America the heebie-jeebies. His powerful think tank and lobbying group—an arm of religious broadcaster James C. Dobson's Focus on the Family organization—is even willing to buck the conservative Establishment. Washington Bureau Chief Lee Walczak and political correspondent Richard S. Dunham talked with Bauer about why Big Business and the Republican Party seem increasingly at odds.



BAUER: A stern warning to multinationals

Q: Are the days of Big Business dominance of the GOP over?

A: My gut instinct is that with each passing day, the Republican Party at the grass roots becomes much more of a Main Street, entrepreneurial, social-conservative party. I would say to large businesses that you should be part of this coalition, particularly to the extent that you want less government regulation and lower taxes and less bureaucracy.

Q: Why all of the conflict between big, international business and social conservatives?

A: The conservative Republican coalition places a high premium on [love of] country. It was jarring to that coalition to hear antiwar demonstrators in the '60s saying they didn't love America. And it's jarring to hear some multinationals suddenly anxious to signal that they're not American companies anymore.

Q: The Administration's engagement policy with China is based on the premise that the magic of the mar-

ketplace will break down Marxist ideology. Do you dispute this?

A: This clearly is not Mao's China. I'm sure part of the change has been due to interaction with the West. But I can make a more convincing case that trade with China is changing us rather than changing them. Suddenly, because of the fear of losing contracts, we begin to quiet our rhetoric on human rights.

Q: Do you think the GOP Congress shares your view of China sanctions?

A: The [China trade] debate has been deeply disappointing. I believe that policy has been driven by a tremendous corporate lobbying campaign, which a large number of congressmen don't seem to be willing to buck. That's quite depressing.

Q: Big Business seems to like the President's call for tougher education standards and national student testing. What's your beef?

A: I'm very much for preparing the workforce for the jobs of the future. And I'm very much against allowing the Washington bureaucracy to get within 100 miles of being the ones that do that. The thing that's curious to me is why corporate executives who understand quite well why Washington will regulate a business to death seem to lose their good sense when it comes to the negative impact of the 15,000 bureaucrats at the Education Dept. [reforming schools].

Q: Some Hill Republicans put their muscle behind an attempt to ease the marriage-tax penalty. Others emphasize the need for a capital-gains reduction. Why all the back-and-forth?

A: There has not been a very consistent approach. I think it's going to be a deep disappointment around the country if we don't get any kind of improvement in the marriage penalty. I'm in favor of capital-gains cuts as well. It's sad that these things are increasingly seen as either-or.

Q: How seriously should Republicans take the threat that religious conservatives might sit out the '98 elections?

A: It would be a tragedy if they sat it out. What does my instinct tell me? They will probably turn out fairly well. And it'll probably make a difference in [the GOP's] keeping Congress.

Q: You're clearly toying with a Presidential run. Could your identification with the Religious Right turn off independents and suburban moderates?

A: As John F. Kennedy reminded us, there is no religious test for office.



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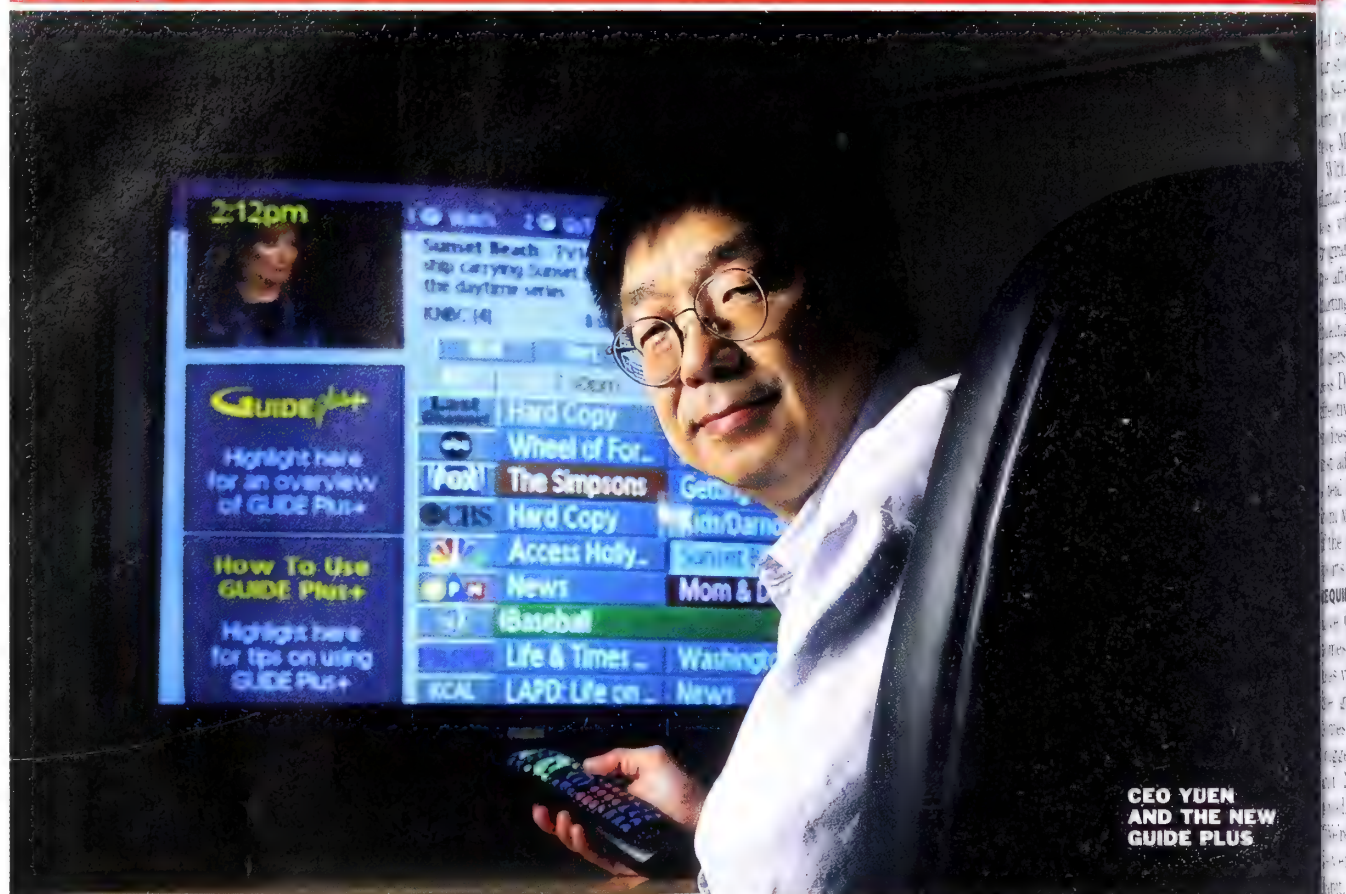
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**CEO YUEN
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TELEVISION

WHAT'S ON TV? ASK HENRY YUEN

His hot on-screen guide is made for the Digital Age—and patents virtually lock out rivals

Henry Yuen is building a portal. He doesn't call it a portal, the current buzzword of the Internet, where such familiar names as Yahoo! Inc. and America Online Inc. are vying to be consumers' preferred gateway to the World Wide Web. Rather, Yuen, president and CEO of little-known Gemstar International Group Ltd., has a far more mainstream frontier in mind for his invention: your television set.

Eight years ago, Yuen and his colleagues made one fortune by coming up

with an easy way to record TV programs with their VCR Plus technology. Now Yuen is out to make a second one, developing and licensing to TV and VCR makers an electronic program guide that helps viewers easily sift through TV shows—a handy tool for the coming proliferation of digital channels.

The way Yuen figures it, the era of interactive television, including transactions, video-on-demand, and Internet access, will just add more entries in his electronic directory: Yahoo! and Netscape Communications Corp. become channels alongside Animal Planet and Home Box Office. "This technology gives you both a search engine and a delivery mechanism that can include broadcast, cable, satellite, and the Internet," says Gary Arlen, president of

consultant Arlen Communications Inc. in Bethesda, Md. "That's about all you need in a digital world."

Moreover, Yuen has made a career out of gobbling up patents and defending them in court, making it virtually impossible to launch a guide without cutting a licensing deal with Gemstar. When its Guide Plus rolls out later this year, Gemstar will be poised to collect rich license fees from manufacturers whose TV sets or cable set-top boxes receive the guide, along with revenue from companies that want to advertise in it. Yuen has already acquired most of his competitors and signed lucrative deals with such industry giants as Microsoft Corp., NBC, and France's Thomson Consumer Electronics Inc., the leading TV maker in the U.S.

But Gemstar's success has created some sticky situations for the feisty Yuen, who holds a 12.4% stake. While he successfully rebuffed a recent takeover attempt by cable baron John C. Malone, he did so without the backing of chairman and 24%-owner Thomas L. H. Lau and other big shareholders such as Thomson and Viacom Inc. Yuen faces fresh challenges both within and outside his boardroom, including a shareholder suit launched against Gemstar's directors over the way they han-

ed the takeover bid. Since July, Gemstar stock has drifted down to \$33, from a \$45-per-share bid Yuen and the majority of directors rejected, and few believe Malone has gone away for good. With all the exciting possibilities for digital television and its plethora of channels, why all the fuss about an on-screen program guide? "The thing that people care after is capturing the viewer at the starting point—where the viewer will be making his choices," says Thomas S. Rogers, president of NBC Cable and Business Development. "It becomes a keenly effective way to direct people to your choices." NBC signed on as the guide's first advertiser in July and also sewed up a deal to provide a live-text feed of news from MSNBC and CNBC on some versions of the guide. "And we're thinking about a sports ticker," adds Yuen.

REQUIRED READING? He is hoping to have Guide Plus installed in 2 million homes by the end of next year and figures viewers will look at three pages of the guide four times an hour. That comes to 168 million page views a day, bigger than Yahoo! and Netscape combined," Yuen says. "We're launching on a seven-hour-a-day orbit, vs. the typical 15-minute Internet session, and we're the only program guide in the box."

If it's starting to sound like an Internet portal, there's good reason. First, Guide Plus pops up automatically when the TV set is turned on. There's a reduced view picture of the channel the set is tuned to in the upper left-hand corner. The bottom two-thirds of the screen is a listings grid from which viewers can sort programs by time or category—say, movies or sports. Couch potatoes can also preset the guide a week in advance to tune in and record shows. Each page has room for three ads. And within a few years, says Yuen, clicking on ads will initiate sales transactions.

Until now, Gemstar has made its money on license fees. Last year, the Pasadena (Calif.) company earned \$39 million on revenues of \$127 million, almost all of it by licensing VCR Plus to VCR makers. While Gemstar will still get a hefty license fee, now about \$10 a unit, for its Guide Plus technology, advertising and a cut of transactions is where the real money is. Claims analyst Alan S. Gould of Gerard Klauer Mattison & Co.: "Whoever owns the advertising on this screen owns the most valuable piece of real estate on the TV."

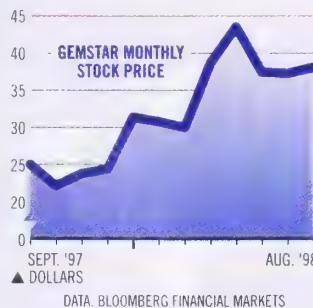
It's little wonder, then, that everyone from William H. Gates III to Malone, chairman of Tele-Communications Inc., is pounding on Gemstar's door. Earlier this year, Microsoft and Gemstar struck a deal in which the software giant would pay \$45 million for the rights

to use the program-guide patents, of which Gemstar holds more than 60. In addition, it will pay Gemstar a royalty of about \$10 for every guide it ships on WebTV and Windows CE systems embedded in cable-TV set-top boxes. "We wanted to create a similar experience across a wide range" of platforms for viewing TV, says Steven Guggenheimer, Microsoft group product manager for digital TV.

Microsoft and other companies have found they have little choice but to do business with Gemstar. Thomson, maker of RCA TVs, discovered this in 1994 when it created its own interactive guide, says Louis E. Lenzi, Thomson's vice-president for new media. "After we developed it, our lawyers told us that we had to take a license from [Gemstar]," he says.

Yuen has found

RISING STAR



Malone to be a much tougher customer. Tulsa-based United Video Satellite Group Inc., which is controlled by TCI, has tried to get its hands on Gemstar's technology, first with a failed joint venture, then with a takeover bid. United Video's Prevue Networks Inc. is currently the leader in on-screen TV listings, with 45 million of

the country's 65 million cable-TV households. But Prevue's listings aren't interactive; they simply scroll by at an agonizingly slow pace for the digital world.

On July 2, United Video launched its unsolicited \$2.8 billion bid for Gemstar. It had just agreed to pay \$2 billion in cash and stock for News Corp.'s *TV Guide* properties to get a recognized brand name—all too aware that Yuen had already secured the rights to the name "TV Guide Plus."

POISON PILL. Gemstar's board promptly adopted a poison pill. Later, it rejected the offer outright, and Malone pulled his bid, triggering the shareholder lawsuit against the directors. Several days later, Gemstar sued United Video for copyright infringement when Prevue announced it had rolled out an interactive version of its program guide in 650,000 homes. Malone's options now include battling Yuen through the courts, negotiating a friendly deal, or launching a proxy fight with the support of Lau and other shareholders. Peter C. Boylan III, United Video's president, contends Malone doesn't need Gemstar. "I'm not sure we'll be back," he says. "We are off to the races building our business."

Whatever happens, Shanghai-born Yuen, 49, who emigrated from Hong Kong to the U.S. to get a PhD from California Institute of Technology, has proved himself a master at bridging the gap between technology and technophobic consumers. He has also shown he can tangle with some of the media world's biggest guns and fend off critics. Some shareholders have grumbled about his new pay package, which awards bonuses based on earnings growth and could grow to \$22 million in 2005. Counters Yuen: "I deserve every bit of it. For me to get all that, our investors would be very rich." No one seems to doubt that is going to happen. The only question is whether Yuen will be the man holding Gemstar's remote.

By Larry Armstrong in Pasadena

NOW SHOWING: GEMSTAR'S GYRATIONS

JAN. 12 Microsoft and Gemstar announce long-term cross-license agreement

JAN. 20 TCI's United Video Satellite Group and Gemstar announce joint venture, which falls apart

JULY 2 United Video makes \$2.8 billion cash bid for Gemstar

JULY 12 Gemstar board adopts poison pill, expands Microsoft deal

JULY 16 Gemstar board rejects offer, announces that NBC will be first advertiser on its new program guide

JULY 22 United Video withdraws Gemstar offer; shareholder sues Gemstar directors

JULY 27 United Video announces its own Prevue Interactive TV guide is in 650,000 homes; Gemstar sues Prevue for copyright infringement

AUG. 18 Gemstar launches \$100 million share-repurchase plan

DATA: BUSINESS WEEK

RUSSIA

A QUICK ROAD TO RUIN

As Russia's economy grinds to a halt, the political standoff stymies hopes of easing the mounting crisis

It was not the most propitious moment for President Bill Clinton to sing hymns to globalism's glory. In Moscow stores, prices of imported coffee and beer had risen 80% in two weeks, while the price of cigarettes had doubled. Cereals and medicines were running short as panicky shoppers took to hoarding. Russia's government was paralyzed as the Duma rejected President Boris N. Yeltsin's nomination of bureaucrat Viktor S. Chernomyrdin as Prime Minister. Amid mounting chaos, Clinton arrived to meet Yeltsin—and exhorted students at a prestigious policy institute: “To get your fair share of investment, you have to play by the rules.”

Rules? What rules? Although Yeltsin promised Clinton that Russia would stick to its reform path, the reality looks just the opposite. The economy is grinding to a halt as Communists in the Duma pressure Yeltsin for concessions in exchange for approving Chernomyrdin. Businesses are freezing their activities while they wait to see how low the ruble will fall and whether defunct banks will work again. Yet the political standoff has stymied hopes of easing the crisis. “Without a government, Russia has little to say on the economic front, except perhaps ‘Help!’” says Thomas Adshead, research chief at Moscow's United Financial Group. **“POLITICAL WHORES.”** The stage is set for a political showdown in early September. If the Duma fails to approve Chernomyrdin in a second or third vote, Yeltsin says he will use his constitutional right to dissolve the legislature, rule by decree, and call early elections.



Some analysts believe Yeltsin might postpone elections beyond the allowed four months. Both sides are playing hardball. And Russians and foreigners alike are disgusted by the politicians' grab for power as the economy worsens. Complains a Western banker: “It's like watching political whores scramble over kopeks on the floor.”

If he's approved, Chernomyrdin is promising to deal promptly with the currency crisis, protect peoples' savings, and pay back wages and pensions. He is expected to announce restrictions on

currency convertibility and the government takeover of some banks, which may involve a bank holiday and transferring citizens' deposits to the state savings bank, Sberbank. Insiders say he will try to boost Russian banks' liquidity—and ease investors' ire—by giving holders of defaulted Treasury bills better terms than the meager 17¢ on the dollar offered under the recent forced debt swap. And he is calling for tax cuts to spur industry.

All this will take money—something the government doesn't have unless it turns on the ruble printing press. Given the populist turn in Russian politics, there are no strong political groups arguing against inflationary policies. The have-nots are ready for a handout, and Yeltsin knows it. Polls show that up to 75% of voters would favor the Communists if an election were held today.

HIGH ANXIETY
How much can Clinton help as Yeltsin faces a near meltdown?

While the politicians vie for power, the economic picture grows more dire every day. Financial-services companies and retailers are



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JAPAN

MAZDA LEARNS TO LIKE THOSE INTRUDERS

Ford's takeover was a shock.
Now the alliance is key



Mazda Motor Corp. lost face back in May, 1996. That's when the hemorrhaging, Hiroshima-based company turned to a *gaijin* for help: Ford Motor Co. took control by boosting its stake from 25% to 33.4%. Just the thought of foreign control sent shock waves through Japan's No. 5 carmaker. Outside the company, commentators referred to the deal as the second atomic bomb dropped on Hiroshima. Customers deserted Mazda's showrooms.

In a turnabout, the alliance with Ford is now seen as crucial to Mazda's pulling out of its skid. While the slowdown in Japan and Southeast Asia has Japan's auto heavies—Toyota, Nissan, Honda, and Mitsubishi—throttling back production, Mazda is more than holding its own. Its sales in Japan are off only 5.8% so far this year, vs. 14.9% for the industry. Facing increasingly harsh competition, Mazda employees from the executive offices to its showrooms are accepting the U.S. auto giant as a necessary ticket to the millennium. "Ford's involvement was essential for Mazda's recovery," admits Kei Kado, managing director of product development.

With guidance from Ford, Mazda has trimmed costs while wheeling out a string of popu-

FAMILY STYLE
The Capella station wagon is a hit in Europe

ZIPPING ALONG

Mazda's MX-5 sports car has gotten a face-lift—and a sales lift, too

lar new models, including the \$11,900 Familia compact station wagon in Japan. At the same time, it's gaining enough ground in North America and Europe to reach breakeven after losing \$93 million in those markets last year. Overall, after five years in the red, the company expects to net \$215 million on sales of \$15.3 billion in the fiscal year ending next March.

"LIKE A GOD." Mazda has pulled the plug on unprofitable lines, such as 660cc minicars. It now slaps its nameplates on minicars produced by Suzuki Motor Corp. Ford executives have reined in Mazda's freewheeling engineers, forcing them to share auto "platforms" and source more components overseas. A company that used to roll out a dizzying array of expensive sporty sedans now produces cars that people want at affordable prices. "We were engineering-



driven," says Kado. "Now we treat the customer like a god."

By following Ford's advice to use customer clinics, Mazda took the lead in one of the fastest-growing segments of Japan's hammered auto market: cabased compact sport utilities. Its \$8,800 Demio compact station wagon is a hit because it gives young families what they asked for—a roomy interior.

Mazda faces a test next month, when competitors roll out 18 new models, including minicars that could lure away potential Demio buyers. Mazda will fight back with new Familia. It will also launch three new minicars, followed by new recreational vehicles based on its Capella station wagon.

Mazda is hardly home free. In Japan, it holds an estimated 5.5% of a market that's expected to shrink some 10% this year, to 5.6 million vehicles. "It's our objective to take on costs to offset the loss in revenue," says James E. Miller,

Mazda's president. This year, Mazda will churn out 1 million vehicles worldwide vs. 1.4 million at its peak in 1990.

For future growth, Miller has his eye on North America and Europe. Led by a new Protégé sedan, Mazda's U.S. sales are up 8% through August, to 177,351 cars. And in Europe, due to the popularity of its \$20,737 Capella station wagon and the newly remodeled sports car sold as the \$21,537 MX-5, Mazda sales have swelled by 11% this year. Mazda plans to push up European sales by increasing exports.

Mazda and Ford also want to get more mileage out of their relationship. Mazda, for example, recently closed a factory in Thailand and will make pickups there in a joint venture with Ford. In 1999, Ford is expected to start building a next-generation SUV based on the Mazda 626.

With Mazda still carrying a hefty debt load of \$5.3 billion, staying tight with Ford could be critical. "Customers feel more confident that Mazda will remain because of its relationship with Ford," says Dai

Watanabe, a salesman at a Mazda dealership in Tokyo. Survival, seems, has turned into a strong selling point in Japan.

By Emily Thornton in Tokyo

How enterprise software helped cut Parker Hannifin's market down to size.

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INDIA

LOOK WHO'S GAINING ALTITUDE IN INDIA

Jet Airways is the airline industry's surprising highflier

On Sept. 1, India's Tata group withdrew a proposal to start a domestic airline. Ratan N. Tata, head of India's largest conglomerate, pulled the plug after the government deferred approval for the 20th time since 1995. Tata executives had gathered in New Delhi in hopes that regulators would give the green light, a signal that the country was allowing more competition. Instead, they could only troop back dispiritedly to headquarters in Bombay.

But one man, who had camped out in New Delhi for the past two months, returned to Bombay triumphant: Naresh Goyal, founder and chairman of Jet Airways, India's premier private domestic carrier. Critics say Goyal's intense lobbying undid Tata's bid, and that the government is playing favorites. "It's obvious the government has two sets of rules for two different people," says Subhash Gupte, a former chairman of Air-India. Jet Airways managers dispute that. Whatever the case, Goyal's story shows how a shrewd entrepreneur can defy even the country's mightiest conglomerate.

Since India started to dismantle the monopoly of state-owned Indian Air-

lines, the domestic carrier, in 1992, seven private airlines have sprung up. Five of them have gone out of business, but Jet Airways has been an exception, thanks to Goyal. Starting out as an office boy, Goyal, 49, spent more than 20 years building up a successful travel agency in Bombay, making excellent contacts with foreign carriers along the way.

DEEP POCKETS. When he saw his chance to start an airline in 1993, Goyal talked Kuwait Airways Corp. and Gulf Air into investing \$4 million each, while putting up \$12 million of his own. That made Jet Airways far and away the best-capitalized startup. Goyal leased relatively new Boeings and hired airline executives from around the world to help him.

The result has been a romp. Neither frumpy Indian Airlines nor poorly financed private rivals can compete with Jet's onboard service, impressive 30-minute turnaround time between flights,

DELHI COUNTER: Jet is winning with strong service and short layovers

and average passenger loads of over 70%. Saroj Datta, a former Air-India and Kuwait Airways executive who is Goyal's chief lieutenant, also gives credit to his boss's obsession with quality. When he's on a Jet Airways flight, Goyal grills the crew and scours the aircraft for upholstery stains and carpet rips. The effort is paying off: In the latest fiscal year, revenues rose 32%, to \$300 million. Profits were \$11 million.

Yet Jet Airways may not have succeeded if Tata had gotten airborne. Tata has plenty of capital, and it recruited a powerful ally, Singapore Airlines Ltd., to help operate the new carrier in exchange for equity. So as soon as Tata petitioned the government, Goyal went into action. He rapidly expanded from six planes to its current 22 to reach critical mass before Tata got going.

XENOPHOBIA. That was smart, but critics allege that in his zeal to outwit Tata Goyal took advantage of his close ties with legislators and regulators. Datta retorts that any business tries to minimize competition. But as for rumors that Goyal exerted undue influence on Parliament, he says: "This is malicious information circulated to tarnish our reputation."

Could be. Indian politics is a nasty game. But the government has thrown many obstacles in Tata's path, and legislators have charged that Tata was a front for Singapore Airlines' bid to rule India's skies. This xenophobia prompted regulators last year to ban foreign carriers from investing in domestic airlines. Tata dropped Singapore as a partner,



GOYAL: Critics say that Jet's founder blocked Tata's bid

and Goyal bought out his Arab shareholders. But legislators still claimed Tata was working with Singapore, prompting Tata to give up. "We were not willing to wait endlessly," says Tata's Eric Vas, manager of the project.

Now nothing should stop Goyal, except possibly his own ambition. He recently borrowed \$400 million to increase his fleet to 32 jets. Bankers and airline analysts say such fast expansion often proves the downfall of young airlines. Either an

economic downturn cuts travel dramatically or harried crews cannot keep the planes arriving safely on time. Goyal, however, has defied the odds before. For now, he is India's only airline mogul.

By Manjeet Kripalani in Bombay

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EDITED BY CHRISTOPHER POWER

THE PHILIPPINES NEEDS AN ACTION HERO, BUT ESTRADA MAY NOT BE IT

Rumors of coups d'état never surfaced in Manila when General Fidel V. Ramos was president of the Philippines. But in late August, just two months after Ramos stepped down to make way for successor Joseph Estrada, disaffected army officers were reported to be plotting one. Estrada summoned his top generals to demand their loyalty, and the rumors died down. But the episode underscores the shaky start of a president already viewed as a weak and ineffective leader.

Estrada, a former movie star, took office on June 30, with a landslide election victory and a clear mandate to help the poor. Although the elite distrusted him, voters thought Estrada was another Ronald Reagan, the great communicator who knew how to rally support while delegating the rigors of economic policy to subordinates. But Estrada has stumbled. He has fought publicly with opponents over issues such as moving the burial place of dictator Ferdinand Marcos, made careless statements about the economy, and allowed cronies from the Marcos era to reassume key business posts. Manila is reeling from "the lack of serious leadership," says a regional investment banker. If Estrada cannot assert strong leadership fast, political and economic problems could wipe away the gains of the Ramos era—and another Asian country could succumb to the ravages of regional crisis.

"MATTER OF EMPHASIS." These moves are drawing an avalanche of criticism and wasting the administration's energies just as the Asian crisis is catching up with the Philippines. Far from growing this year, as was expected, the economy contracted at an annual rate of 1.2% in the second quarter. Meanwhile, unemployment has risen to more than 13%, and inflation is nearing double digits. Analysts fear nonperforming loans could reach 20% of bank portfolios.

The situation cries out for leadership. But Estrada's initial

moves have spooked investors. In a speech on July 31, he bluntly announced that the government was bankrupt. It's not. But the stock market plunged, now down 36% for the year. Cabinet officials have scrambled to attempt damage control. Finance Secretary Edgardo Espiritu says Estrada's statement was "a matter of emphasis" rather than fact. He adds: "We have not lost our direction. Our feeling is we can restore confidence, and we have solutions to the problems."

They include spending an additional \$545 million—bankruptcy speech or no—on rural infrastructure and housing by the end of the year as a way to spur growth. "As you develop more farm-to-market roads and irrigation, you provide job opportunities," Espiritu says. But first the government must find the money. It already has a \$1.6 billion budget deficit and depends heavily on foreign handouts. To find new money in the budget, Estrada has proposed cutting the funds that powerful members of Congress use for social "pork barrel" projects back home. While that would save about \$1 billion, most analysts deem the plan politically untenable. Estrada also wants to freeze military spending—an unpopular idea with an already disgruntled army.

Estrada would have a better chance of pushing through programs if he could coordinate policy better. But the power vacuum has resulted in squabbling cabinet secretaries jockeying for dominance. There are also concerns that Estrada is out of touch: When the U.S. Navy conducted joint military exercises with the Philippines in early August, Estrada telephoned his defense secretary to ask what the devil was going on. The commander-in-chief, clearly, had not been informed. In his movie days, Estrada usually played a take-charge guy. He needs to also play that role in office.

By Sheri Prasso in New York and Hugh Filman in Manila



ESTRADA: Out of touch?

GLOBAL WRAPUP

RUSSIAN BOON FOR ISRAEL

► Israel believes there's a silver lining to the crisis in Russia. Immigrant Absorption Minister Yuli Edelstein says increasing numbers of Jews from Russia and Ukraine have been heading to Israel since economic and political turmoil flared up there in August. Edelstein, a Russian immigrant himself, is expecting up to 100,000 Russian Jews to seek permanent residency this year. In recent years, 65,000 to 70,000, out of a community of 1 million to 1.5 million in Russia and Ukraine,

have settled in Israel annually. Israeli officials believe immigrants help spur economic growth, which is stuck at about 1.5% this year.

A NORTH KOREAN MISFIRE

► North Korean officials have never been above brinkmanship, but this time their game may have backfired. The military test-fired a new ballistic missile over a Japanese island and into the Pacific Ocean on Aug. 31, prompting outrage in Tokyo. North Korea may have been aiming at gaining concessions in ongoing talks with

U.S. and South Korea in New York. But Japanese officials say they are no longer interested in restoring diplomatic relations with Pyongyang. And Tokyo says it's withdrawing its pledge of \$1 billion to help pay for North Korean nuclear reactors—part of the discussions in New York. But even though North Korea may have lost money and diplomatic goodwill, the missile firing may end up a morale booster for its military. The incident happened just as leader Kim Jong Il prepares to assume his title as President and head of state.

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Who is James Curvey? He just may be the man who saves Fidelity from itself

During the four-day, 1,000-point stock market debacle that started on Aug. 26, the atmosphere at Fidelity Investments in Boston was less hectic than on the floors of the stock exchanges. With many fund managers on vacation, trading fell to half its normal volume of 5% to 7% of all Wall Street trades. Telephone calls from shareholders increased. All told, customers moved some \$2.5 billion from Fidelity's equity funds into money-market funds. That's nothing to sneeze at, but it's a pittance compared with the \$487 billion in equity-fund assets managed by the nation's No. 1 fund company. Dividend Growth Fund manager Charles Mangum, who interrupted his beach vacation to go bargain-hunting for beaten-down financial stocks, says: "Hey, markets go down, too." He adds: "It's a good excuse to upgrade your portfolio."

Fidelity has been doing a lot of upgrading beyond Mangum's fund. Even with August's gruesome rout, Fidelity funds are holding up well against their peers. For the year through Sept. 1, Fidelity's U.S. diversified equity funds ranked No. 2 in performance among the nation's 10 largest fund companies, according to a Morningstar Inc. analysis conducted for BUSINESS WEEK.

Finance

Of course, nearly all funds are getting hit. Fidelity's average returns of -1.9% for 1998, and 0.6% for the past 12 months aren't anything to brag about. But this year's performance is only half a percentage point behind the leader, American Funds Group, and is nine percentage points ahead of Franklin, the laggard (table, page 180).

Indeed, Fidelity is mounting a comeback after its crisis in 1995 and 1996. In the midst of a strong bull market, many of its biggest funds turned in poor performances as a result of unchecked asset growth and wild bets that went bad. Many top fund managers bolted, and the company faced heavy criticism from customers and investment pros. The giant's returns so dismayed investors that in the fourth quarter of 1996, when its rivals were taking in billions, it suffered net outflows of \$158 million. The flagship Fidelity Magellan Fund still has not recovered. Since April, 1996, investors have pulled more than \$11 billion out of the roughly \$70 billion fund even though performance has improved.

"OUT OF CONTROL." Behind Fidelity's attempt at renewal is a complete overhaul of the mutual-fund operation and an even broader restructuring of the entire Fidelity empire. Those changes include a brand-new national TV and print advertising campaign featuring former Magellan manager Peter Lynch and comic Lily Tomlin. In a sharp break from past campaigns, this one doesn't push particular products but rather encourages people to seek advice at Fidelity. Later this fall, Fidelity will roll out new brokerage services aimed at making up ground lost to the growing number of financial industry giants targeting Fidelity's turf.

Orchestrating Fidelity's makeover is James C. Curvey, an unlikely character to lead



FIXING

CURVEY SHAKES UP FIDELITY

- Revives mutual-fund performance by installing new management
- Streamlines Fidelity's top management, consolidating 12 jobs into five
- Changes compensation to reward teamwork
- Forces executives to identify and train successors

Fidelity back to health (page 188). Until early last year, Curvey, 63, was president of Fidelity's venture-capital company, watching over a car service, a newspaper chain, and other pet investments of Chairman Edward C. "Ned" Johnson III. Though he had no role in overseeing mutual funds, he was a member of the parent company's nine-man operating committee.

But Curvey says he couldn't stand watching a disaster unfold. So on Mar.

24, 1997, he called a meeting of the operating committee, leaving Johnson out of the loop. Curvey went around the room, criticizing his peers and telling them what he thought they were doing wrong. His primary target was J. Gary Burkhead, president of Fidelity's mutual-fund unit. Curvey also went after former marketing chief Paul J. Hondros, an abrasive former Philadelphia cop who was leading a marketing campaign that was not stopping the bloodletting. After two hours with the committee, Curvey went to the chairman. "Things are out of control," he recalls telling Johnson. His first recommendation: Replace Burkhead immediately. "We've got to get him out of there," Curvey recalls saying. "He's burned to a crisp."

Curvey's tirade was a turning point for Fidelity. Johnson agreed with Curvey. Within weeks, Burkhead was bumped upstairs to vice-chairman overseeing institutional strategy. The following week—on May 1, 1997—Johnson named Curvey chief operating officer, giving him sweeping power over operations. Hondros resigned a few months later. Sixteen months later, on Sept. 3, 1998, Johnson gave Curvey the added title of president, solidifying his authority as Johnson's right-hand man. Says Johnson: "I knew Curvey was right, and I knew he could fix it."

Curvey is radically shaking up Fidelity's corporate culture, trying to repair divisive, behind-the-scenes management problems that contributed to the 1995-96 crisis. He has totally realigned Fidelity's senior ranks and restructured virtually all of its operations aimed at selling products to individual investors, brokers, registered investment advisers, and banks.

Central to Curvey's approach has been to sharply rein in the decentralized, entrepreneurial culture that served Fidelity so well when it was small. Power, once spread among 12 senior managers reporting to Johnson, has been consolidated among five managers. All the top players now have 20% of their bonuses tied to their success in cooperating with one another.

This seemingly innocuous new compensation system is a dramatic step for Fidelity. In the old Fidelity, conflicting goals and competition among top executives led to numerous problems, including redundant technology development and marketing efforts and turf battles over customers. "Suspicion and mistrust among different units" was one factor behind the



JOHNSON (LEFT) CALLED
CURVEY'S SCATHING
CRITICISM "RIGHT"

FIDELITY



NEW TACTIC **44** We came to grips with the idea that even if the [stock] price is rich, if the earnings are good, you can still have good appreciation **77**

— ROBERT C. POZEN, MUTUAL FUNDS

slow development of a Windows-based software program for retail brokerage customers called Fox On-Line Xpress, says Mark A. Peterson, president of Fidelity's computer operations. The three-year delay in developing Fox, followed by a shorter delay in launching stock trading on the Internet, allowed competitors, such as Charles Schwab & Co. to surge ahead in electronic brokerage. Curvey "has forced us to really rethink the way we did things here," says Abigail P. Johnson, daughter of Ned Johnson and a senior vice-president.

Finance

Curvey's insistence on ousting Burkhead as head of mutual funds has proved to be his most prescient move so far—and the one with the most impact on the company's 12 million fund shareholders. Burkhead's replacement is Fidelity's longtime general counsel, Robert C. Pozen, a government affairs specialist who declined an offer to become President Clinton's lead Far East trade negotiator when he signed on to his new job.

funds had grown so large they could no longer nimbly maneuver through the market as they had in the past. The size problem, many worried, made them less likely to ever again produce the spectacular returns they achieved when they were smaller. In 1993, for example, 19 out of 20 Fidelity growth funds beat the Standard & Poor's 500-stock index, many by a margin of more than 2 to 1.

CLIENTS DEFECT. That incredible performance led investors to pour money into Fidelity at unprecedented rates. Faced with billions of dollars in new cash, many fund managers in 1994 began sidestepping Fidelity's traditional approach of investing in a diversified array of hundreds of fast-growing small and midsize companies in favor of making big bets on whole sectors of the economy, such as technology stocks or government bonds. Some funds strayed wildly from the objectives described in their prospectuses. The Blue Chip Growth fund, for example, invested heavily in unknown small-cap stocks.

Even worse, performance was hurting Fidelity's reputation

Fidelity's Looking Better Against the Competition

How it stacks up against its rivals, short- and long-term

CUMULATIVE AVERAGE TOTAL RETURN*

FUND GROUP	YEAR TO DATE	FUND GROUP	1-YEAR	FUND GROUP	3-YEAR	FUND GROUP	5-YEAR
AMERICAN	-1.4%	AMERICAN	3.4%	AMERICAN	55.2%	VANGUARD	112.7%
FIDELITY	-1.9	FIDELITY	0.6	VANGUARD	55.0	FIDELITY	105.4
AMER. CENTURY	-5.1	PUTNAM	-2.3	T. ROWE PRICE	50.3	T. ROWE PRICE	103.0
VANGUARD	-5.3	T. ROWE PRICE	-3.6	FIDELITY	48.1	PUTNAM	102.4
PUTNAM	-5.5	VANGUARD	-3.7	PUTNAM	47.5	AMERICAN	98.3
AIM	-6.8	IDS	-4.7	IDS	44.3	FRANKLIN	95.2
IDS	-6.8	AIM	-5.3	FRANKLIN	41.9	AIM	91.4
MERRILL LYNCH	-7.4	AMER. CENTURY	-5.6	AMER. CENTURY	41.1	AMER. CENTURY	82.9
T. ROWE PRICE	-8.5	MERRILL LYNCH	-7.5	MERRILL LYNCH	38.2	IDS	80.1
FRANKLIN	-10.9	FRANKLIN	-8.7	AIM	36.3	MERRILL LYNCH	77.3

Average returns are for 10 largest fund companies (excluding money-market funds); returns exclude index funds

*Appreciation plus reinvestment of dividends and capital gains before taxes for time periods ending Sept. 1, 1998, preliminary results

DATA: MORNINGSTAR INC.

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NEW RIGOR Curvey has the blessing of Fidelity's heir apparent. "[He] has forced us to really rethink the way we did things here," she says

— ABIGAIL P. JOHNSON

with companies that offer mutual funds in their 401(k) plans. It began losing new business to such rivals as Putnam Investments, which at the time had better returns.

Pozen's predecessor, Burkhead, put an end to the wild sector bets and ordered managers to stay within the investment objectives outlined in the prospectus. But Pozen directly responded to the most serious complaint from the outside: the unchecked growth of the funds. Soon after taking charge, he closed Fidelity's four biggest funds to new retail investors: Magellan, Contrafund, Low-Priced Stock, and Growth & Income.

Finance

A number of smaller fixes are also helping. Pozen cut the workload of some managers and appointed apprentice managers for some smaller funds. Fidelity's 248 analysts have been divided between small-cap and large-cap stocks and seven specific industry sectors. Analysts now cover only 35 companies instead of 68 and spend two years specializing in an area instead of one.

HONING DATA. Other changes, as well, are helping the funds gain against rivals. One is a new stock-picking approach that is changing the way Fidelity invests. Under the old system, devised by Lynch, Fidelity focused on buying companies with strong earnings growth that were likely to beat Wall Street earnings estimates, and it traded aggressively in and out of these mostly small- and mid-cap stocks.

Now, Fidelity is less concerned with beating the Street's earnings estimates and is focusing more on companies with consistent earnings growth. "We came to grips with the idea that even if the price is rich, if the earnings are good, you can still have good appreciation," Pozen says.

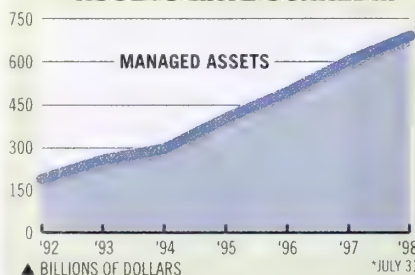
This has led many Fidelity funds into large stocks, such as Coca-Cola and Microsoft, that have high price-earnings multiples. Now, says Dividend Growth Fund manager Mangum, "I'm much more willing to take multiple risk than earnings risk," in part because the fast-growing, smaller companies Fidelity used to favor tend to get pummeled by investors if they have even slight earnings problems.

The most valuable information, Pozen says, identifies holdings that are underweighted relative to a fund's benchmark. If a fund whose bogey is the Standard & Poor's 500-stock index has 1% of its money in Intel Corp., it's a negative bet since Intel constitutes 1.6% of the index. The fund will suffer against its benchmark if Intel does well.

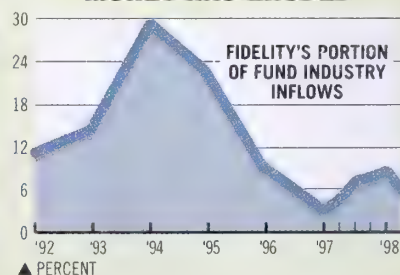
The system prods managers into paying more attention to their smaller holdings, which often get short shrift in a large portfolio. The idea is that if a manager likes the stock, he or she should consider increasing the position. Conversely, those positions that are underweighted because the manager has cooled on the company may be targets for sale. Fund manager Mangum says this analysis has helped him run his \$7 billion fund by eliminating smaller positions, which take time to monitor but have little impact on returns. "If I can't own at least 1% of a company, why bother?" he says. So he has used the quarterly reports to help him trim his portfolio down to 123 stocks, from 250. Many of his top holdings are now also heavily overweighted compared with the weighting they get in the S&P 500, Mangum says.

Fidelity has another analytical tool that can help improve performance. Funds that trade aggressively have high trading costs, which can hurt returns. So, Fidelity now produces a separate report monthly showing how much a fund might save if it reduced its trading. Not all managers use it—Mangum, for one, says smart stock-picking should more than overcome the increased cost of trading. But many Fidelity

WHILE FIDELITY'S TOTAL ASSETS HAVE SOARED...



...ITS SHARE OF NEW MONEY HAS ERODED



DATA: FIDELITY INVESTMENTS, FINANCIAL RESEARCH, BUSINESS WEEK



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STREAMLINING: The Merrimack (N.H.) internal operations center controls data processing

After pouring millions into competing processing systems, Fidelity is consolidating

funds are trading noticeably less than before. Magellan, for example, turned over its portfolio about once every ten months in 1995, but now it's nearly once every three years.

The jury is still out on whether Fidelity's revamped stock-picking machine will bring back its halcyon days when many funds routinely beat the market. The new analytical tools may not help the behemoth funds very much if the market starts to favor small- and mid-cap stocks.

Some Fidelity watchers, including several former Fidelity fund managers, argue that some larger funds now look more like index funds. Eric Kobren, publisher of *Fidelity Insight*, calculates that some large funds, such as Growth & Income,

have a 98% correlation with the S&P 500 over the past three years. One former manager says: "All these guys are getting paid to do is

tweak indexes." Says another: "It's a form of indexing... a certain amount of S&P stocks need to be in the fund."

NEW CANDOR. Abigail Johnson, who oversees the Fidelity growth funds, dismisses that claim. "That's not supportable if you look at the data." Fewer than half of Magellan's holdings were in the S&P 500 earlier this summer. Pozen notes that most funds are invested in a wide variety of holdings beyond the S&P 500. For example, as of June 30, only 118 of Contrafund's 336 stocks were S&P 500 issues.

Some of Fidelity's harshest critics from a few years ago now think it is making the right moves. David O'Leary, president of Alpha Equity Research Inc. in New Hampshire, had been a vocal critic of Fidelity's forays into sector bets and bonds in 1995 and 1996. But now he says: "Fidelity is back to doing what it does best: stock-picking." Russel Kinnel, editor of *Morningstar Mutual Funds*, says: "Fidelity is coming to grips with the problems of running enormous funds."

Fidelity's turnaround is a work in progress. Company officials have said little publicly about the changes until now, believing they were not complete. But Curvey says the company should acknowledge its past mistakes and move on: "We're almost a public trust here... and we have an obligation to tell people what the hell is going on."

Curvey's candor is refreshing for Fidelity. The privately held company in the past has been loathe to discuss its affairs with outsiders unless boasting about its successes. And Curvey's leadership comes none too soon. The crisis that prompted his secret meeting with the operating committee led to a

the first half of 1998, Fidelity's market share stood at just 7.3% (chart, page 182).

Of course, there's more to this company than mutual funds. One long-held goal left unchanged by Curvey is to diversify the business and make the company's fortunes less dependent on mutual funds. Fidelity now sells dozens of products—both financial and nonfinancial—developed by more than 40 separate companies. The offerings range from stock trading to bond underwriting to insurance and back-office support for brokers, independent investment advisers, and corporate benefits departments.

Johnson built these businesses by exploiting the advantage of being privately held. He incubated each one from scratch—sometimes doubling up efforts to create competition. Many have been funded for years, even if they lost money. Several Fidelity sources say its retail brokerage unit hasn't made a dime in years. Fidelity declines to comment. Many of these units were run by high-ranking execs with their own budgets and total autonomy—and responsibility—to organize and market their products as they wished.

Curvey says this system broke down as Fidelity's growth soared. Before he became COO, Fidelity had 17 internal newspapers and five nearly identical software programs under development for five different parts of the company. Hundreds of millions of dollars in marketing and promotions were being spent on duplicate or competing projects.

Fidelity has been acclaimed for its technological expertise, but that has come at an enormous price. In one oft-cited case by former employees, Fidelity spent hundreds of millions of dollars over seven years developing competing data processing systems to handle customer accounts. Finally last year, one project, called Vantage 20/20, was scrapped despite an investment some former employees estimate at \$50 million. Curvey won't confirm that figure, but he says not a cent of the money spent on Vantage was wasted, since parts of the project have been adopted in other company systems.

Curvey has started cleaning up the mess. He's consolidated Fidelity's computer operations under one executive, Mark A. Peterson, who has built a new computer center in New Hampshire to handle online transactions, which now amount to 60% of brokerage trades. Curvey also named Burkhead to oversee all brokerage and marketing operations, consolidating 11 units. Curvey has also assigned each operating committee member to cross-company projects to force them to work together. And he

Finance

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bases part of their bonuses on how well they develop successors. "None of what I'm doing is rocket science, but we've never had any of this before," says Curvey.

Johnson has wisely decided not to try to rebuild his company alone. At 68, he is preparing for retirement, though he refuses even to hint at when that might come. He ran Fidelity without a

second-in-command for 12 years, but he now is trying to build a management team capable of running Fidelity when he steps down. Although Curvey has been the mover behind Fidelity's shakeup, he will not necessarily succeed Johnson. Johnson says he will decide on his successor when he retires, based on "who's available at the time and what skills the company needs."

FAR ENOUGH? His first choice is Abigail, 36. A former fund manager, she joined the executive ranks last year to help oversee funds and broaden her experience dealing with other parts of the company, including the marketing, public relations, and legal departments. She owns 24.5% of Fidelity's voting stock, potentially worth \$4 billion to \$5 billion if Fidelity went public, according to industry estimates. Her father owns 12%, and other Johnson family members own an additional 13%.

Abigail is the beneficiary of a trust that grants her ownership of Fidelity "for her lifetime" and could keep ownership in the family for another generation as well, her father says. Two years ago, he gave 51% of the company's voting stock to 50 top employees, as a way to reduce estate taxes. Since then, many employees have hoped that Fidelity will go public, producing windfall profits. Fidelity may be worth

\$20 billion in an initial public offering, some estimate.

The trust allows Abigail to sell Fidelity or take it public. But Johnson says he does not want that to happen. "I'm not really going to reach out of the grave and curse her if she does that," Johnson quips. But, he adds, "there wouldn't be any strong financial incentive at all" for her to do so. "If there were good business reasons, maybe it would happen," Johnson adds. Abigail says she wants Fidelity to remain private.

Abigail has her choice of jobs, her father says. She can oversee strategy, head operations, or remain in a lesser role, he says. Abby says she will decide that when the time comes. Her father, she adds, is in excellent health and will "probably never retire. He has worked out regularly with a personal trainer in his Boston home for the past 10 years, and occasionally challenges his aides to a game of tennis."

Whether Curvey and his changes go far enough to solve Fidelity's problems still to be seen. The changes in the mutual-fund unit are untested, particularly in a bear market. The new marketing strategy, which emphasizes advice, is a sharp break from the past practice of promoting funds. And new brokerage products that Fidelity will roll out in coming months, including a voice-recognition trading system and a program to offer customers investment advice, are coming on the heels of similar products offered by competitors.

Fidelity is far from being the money machine it was in the early 1990s. But Curvey has stopped the bloodletting and handed Fidelity back on the warpath.

By Geoffrey Smith in Boston

A companion story follows on page 188

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'THE EXECUTIONER' TAKES CHARGE

James C. Curvey seems like an odd choice for president of Fidelity Investments. He joined Fidelity in 1982 as head of human resources and five years later moved on to run Fidelity Capital, a hodgepodge of businesses unrelated to Fidelity's core mutual-fund operations. But Curvey's ascent is no surprise to insiders at the company. He and Fidelity Chairman Edward C. "Ned" Johnson III hit it off from the start, and Johnson has long used him as a sounding board. A former top Fidelity executive says the two became so close that "Curvey is one of the few execs who will tell Ned he's full of it and not have Ned cut his throat."

It is no accident that Johnson calls Curvey "the Executioner," although for reasons other than his willingness to fire people. For starters, he has made millions for the parent company. Since taking over Fidelity Capital in 1987, revenues have grown from

\$10 million to over \$270 million last year.

Curvey also

oversaw Fidelity's most profitable investment ever outside mutual funds—a 55% stake in British telecommunications company Colt Telecom Group PLC. Fidelity built the company from scratch in 1992, took it public in 1996, and its stake is now worth \$3 billion.

RURAL BACKGROUND. Johnson makes no secret of his admiration for Curvey's ability to execute his business strategies. According to Fred K. Foulkes, a Boston University business professor and longtime Fidelity consultant, Curvey is well-organized and big on setting goals and making sure that they are achieved. "His eyes will roll if you talk about flaky HR [human resources] stuff, like organizational de-

velopment programs," Foulkes adds.

Many current and former executives who have worked with Curvey describe him as someone adept at getting groups of senior managers to cooperate. "He has the ability to keep lots of very strong egos working together," says Metropolitan Life Insurance Co. Chairman Robert H. Benmosche, who worked with Curvey at Chase Manhattan Bank in the early 1980s.

Despite Curvey's blunt style, the executive has made few enemies at Fidelity. Indeed, many considered him their first stop before approaching Johnson with a new idea or difficult problem.

Curvey's background could not have been more different than his Boston blueblood boss's. He grew up in rural Pennsylvania, the son of a co-owner of a coal mine who died in a car crash when Curvey was 12. He struggled in school, and his early career took him from accounting to the Army to law school. Around Fidelity, rumor has it that Curvey worked for the CIA. Not true, he says. Although he did get an offer from the Secret Service to guard President Dwight D. Eisenhower, Curvey turned down the job because

JAMES C. CURVEY
BORN June 9, 1935
HOMETOWN Mahanoy City, Pa.
FAMILY Married, two children
PASTIMES Golf, tennis
EMPLOYMENT
 Fidelity Investments:
 1998 President
 1997 COO
 1987-97 President, Fidelity Capital
 1983-86 Sr. V.P. administration
 1982-83 V.P. human resources
 1976-82 Chase Manhattan Bank, V.P. human resources
 1956-76 U.S. government, various human resources jobs
EDUCATION
 BS Accounting, Villanova University, 1957
 MA Personnel Management, George Washington University, 1962

it required too much travel, he says.

After receiving his BA from Villanova University, Curvey's hometown congressman landed him a job in the U.S. Treasury Dept. answering mail. From there, he jumped to a succession of human resources positions within the department and worked his way up to head of human resources at Housing & Urban Development. In 1976, Curvey moved to the private sector by nailing down the No. 2 human resources job at Chase Manhattan.

Is Curvey CEO material? "The answer is yes," says Benmosche. Still, the odds are against him. Only a handful of executives with human resources backgrounds have ever made it to chief executive, says Foulkes. Curvey won't say when he plans to retire, but he may pack it in before Johnson, who is five years his senior. The current chairman has no plans to go anywhere, and he seems determined to stay on long enough to let his daughter Abigail, a rising executive at Fidelity, grow into his job. No matter who ends up succeeding Johnson, Curvey will remain the key man at Fidelity at least for a few more years.

By Geoffrey Smith in Boston



Finance

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COMMODITIES

AS GOOD AS IT GETS

For commodity funds, August was the time to rake it in

Beating the Index (Lately)

	AUG.	YTD	1997
MAR MANAGED FUTURES INDEX	5.0	5.0	10.1
S&P 500	-14.6	-1.8	25.8

DATA: MANAGED ACCOUNTS REPORT

For most investors, August was the month from hell. Not for William Dunn, though. His firm, Dunn Capital Management, with \$900 million under management, had one of its best runs in years. He's up 25.4% so far this year, and 23.7% in August alone.

Dunn's managed commodity fund trades in futures and options on stocks, bonds, and currencies as well as physical commodities such as copper and oil. His technical trading systems, which follow price trends, has had the fund selling stocks and physical commodities and buying global bonds. "People are running for safety," he says.

"PRETTY CRAZY." The main draw of commodity funds is that, in the long run, their performance has little correlation with stock and bond markets. Until recently, though, managed commodity funds as a group underperformed the stock market for several years. While the Standard & Poor's 500-stock index climbed 106% between 1995 and 1997, the index compiled by *Managed Accounts Report*, an industry newsletter, was up only 45.3%. "It's been difficult competing [for funds] with the incredible bull market in equities," admits Dunn, despite the fact that he has beaten the S&P during the last three years.

Richard Dennis, head of Dennis Trading Group, who manages \$220 million,

also had a torrid month. "Between the ruble, Yeltsin, and the deep blue sea, it's been pretty crazy," he says with a hint of glee. Dennis was up 13.5% in August, giving him a year-to-date return of about 45%. MAR's index of 400 funds was up 5% in August, with trend-based managers up 15.3%.

The \$35 billion managed futures funds business runs the gamut from huge portfolios of institutional money, especially pension funds, to retail pools sponsored by brokerage houses. Physical commodities typically account for only 10% to 15% of the investments a large fund manager will make because of the markets' relatively small sizes. Equity derivatives, including the S&P index, make up 20% more. Currencies and interest-rate products, such as the futures contract on the U.S. Treasury bond and German bund, together account for about 60% to 65% of total investments.

Some two-thirds of the industry's assets are run by fund managers like Dunn and Dennis, who rely systematically on computers to discern and follow historical commodity price trends. That allows them to invest in large numbers of markets without carrying a huge staff of analysts. "We don't make market predictions," says Dunn. "We just ride the bucking bronco."

Sometimes, the ride can be especially rough. Take currency. Most man-

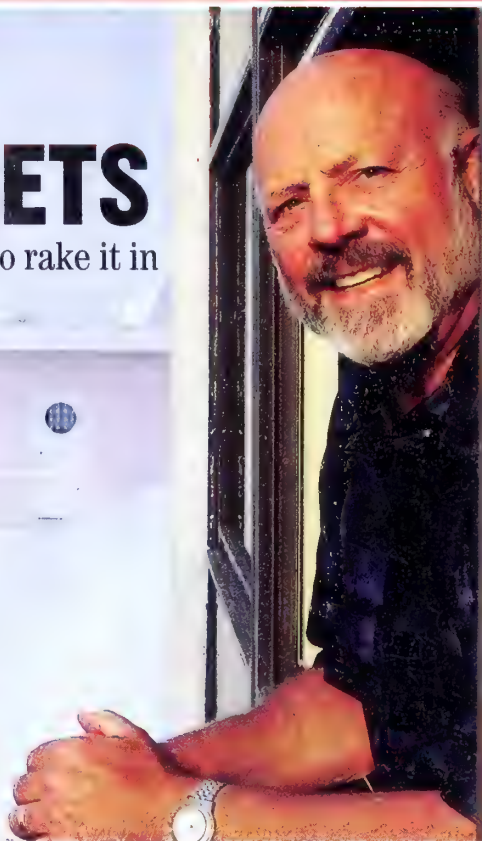
DUNN: His fund, which has loaded up on bonds, is up nearly 24% in August

agers got creamed when the Federal Reserve intervened to halt the slide of the yen on June 17. Other recent trends have been more predictable. And the more enduring the trend, the better the results. The protracted decline in physical commodities prices has enabled John Henry, a systematic trader who runs \$2.25 billion in assets, to make money shorting crude oil and some farm commodities.

The most solid trend has been a flight to quality by U.S. and foreign investors. That means bonds, particularly of developed countries. Skittish investors fleeing equities have poured into the U.S. Treasury market. Prices have soared this year, sending yields to record lows. The same is true of the German bund. Dennis says he made about \$20 million buying bund futures. "It's been a one way trend," says Dennis. "If you haven't made money there, you should be in a different job."

Most commodities plays aren't so easy, of course. But then the stock market doesn't seem too predictable either. With financial markets around the world unstable, commodities funds offer, if not a safe haven, at least a nice option to diversify.

By Andrew Osterland in Chicago





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MUTUAL FUNDS

CRAZY LIKE A FOX?

Two fund veterans bet on the emerging world, crisis or no

As Daniel J. Fuss left church a few Sundays ago, a friend approached him and said she was praying for him and the Loomis Sayles Bond Fund he manages. "I thanked her, since you can always use prayers, but I don't think my bond fund needs any," he says.

Others might disagree. That's because Fuss is "belly-deep" in hugely discounted emerging-market debt he bought in an effort to pump up his \$1.5 billion corporate bond fund's yield and performance. "There's true value in these bonds even if they never trade again," says Fuss.

As expected, the fund has suffered. It lost 4.23% year-to-date and is down 0.61% since Aug. 31, 1997, compared with gains for all corporate bond funds of 4.36% and 8.05% for the same periods. Meanwhile, Franklin Templeton's Mark Mobius, the manager of some \$12 billion in emerging-market stocks, is continuing to buy equities in developing nations even as his funds—such as Templeton Developing Markets, which is down 50% for the year through Aug. 22—take a serious beating. "I'm optimistic because prices are right for the first time in a long time," Mobius said



Daniel Fuss

	YTD*	1 YR.	3 YR.	5 YR.
LOOMIS SAYLES BOND FUND	(4.23)%	(0.61)%	9.09%	9.27%
ALL CORPORATE BOND FUNDS	4.36	8.05	6.99	5.78

*Through 8/31/98

DATA MORNINGSTAR INC.

on a Sept. 1 call to financial analysts.

If these veteran managers are right and emerging markets turn around, their funds will see a spectacular recovery. If they're wrong, the havoc wreaked on returns is likely to burden their funds for a long time to come.

"CAUTIOUSLY." Do they know something others don't? Fuss thinks that as long as he buys world-class companies with little risk of default, then the worst case is that he holds the bonds to maturity. "As long as they pay their bills, we'll make money" despite any price declines, says Fuss. He has invested 17% of his portfolio in mostly corporate Asian and Latin American debt and would buy more if he "could get my hands on it." He's brushing up against the fund's 20% limit in emerging-market debt.

In Asia, where spreads are 700 to 900 basis points over U.S. Treasuries, he is sticking primarily with corporate debt such as Korean Electric, Pohang Iron & Steel, Asia Pulp & Paper, Telekom Malaysia, and Philippine Long Distance Telephone. "In the Great Depression, how many telephone and electric companies defaulted?" Fuss asks. In Latin America, he likes the most widely traded Brazilian Brady bonds, big global issues such as those in Argentina, and a couple

of corporate credits in Chile and Mexico. "The returns on these bonds are four to five times what I can get on U.S. corporates," he argues.

Mobius sees the same value as Fuss but in stocks. He has been buying the way down through the crisis, and his funds show it. The net asset value of his flagship Templeton Emerging Markets is down 23% year-to-date and 39% for the 12 months ended Aug. 22. Templeton Dragon, a Pacific Rim fund that excludes Japan, is down 35.86% and 56.90%, respectively. Mobius thinks there's more bad news to come that will roil the markets. But he's not holding back on his stock purchases: "We're buying cautiously because while prices have come down to dumping levels, many of the companies won't remain in existence."

Specifically, Mobius likes Korea and Thailand because both "have bitten the bullet and are on the recovery trail but trying to adhere to [International Monetary Fund] advice and programs are selling off assets." In Korea, he's buying companies with big capitalizations and lots of liquidity with minimal leverage. While Mobius is avoiding the big blips Hong Kong's government program has attempted to buoy, he says there are "lots of good bargains." In Indonesia, he likes PT Tambang Timah, the largest producer and exporter of tin in the world.

Both Fuss and Mobius have made their mark breaking out ahead of the pack. But given the condition of most emerging markets, a little prayer can't hurt.

By Todd Gutm
in New York



Mark Mobius

	YTD*	1 YR.	3 YR.	5 YR.
TEMPLETON DRAGON	(35.86)%	(56.90)%	(10.97)%	NA
ALL CLOSED-END PACIFIC FUNDS**	(21.12)	(53.44)	(21.64)	NA

*Net asset value through 8/22/98

**Excluding Japan

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A SINKING TIDE DOES NOT LOWER ALL BOATS

The middle class owns so little stock, its exposure is minimal

Throughout the 1990s, average Americans have piled into the stock market through mutual funds, 401(k)s, and Individual Retirement Accounts. America's love affair with stocks made small investors a mainstay of the bull market. Many thinkers even have heralded the dawn of a people's capitalism, one that chips away at the elitism of corporate ownership and wealthy individual investors. So when the market heads south, middle-class America gets whacked in the wallet just like the tycoons at the top, right?

Not quite. A new study by New York University economist Edward N. Wolff shows that most Americans don't have enough stock, even including shares held indirectly through mutual funds, to share in much of the gain—or in the pain either. The study shows that the wealthiest 10% of households enjoyed 85% of the stock market gains from 1989 until the end of 1997, when the markets stood at about where they were after the Aug. 31 sell-off, according to Wolff. His study is being published on Labor Day in *The State of Working America*, a book put out by the Economic Policy Institute (EPI), a liberal Washington think tank.

Says John Ray, an economist at the Investment Company Institute, a trade group of the mutual-fund industry: "It's not terribly surprising that the top 10% has enjoyed most of the gains from the market, because they still have most of the assets in the U.S."

GROWING RANKS. Still, Wolff's study challenges the conventional wisdom about broad stock ownership. It's true that the ranks of small investors have multiplied rapidly: Some 40% of all households owned some stock in 1995, the latest year available, vs. 32% in 1989,

according to Federal Reserve Board data. These figures include all stock held directly or indirectly by households.

But that leaves a solid majority of Americans who own no stock. And those families that do invest don't have enough money in the stock market to reward them with a significant share of the total. Just 29% of households

WHO GOT RICH IN THE STOCK MARKET BOOM



Richest 10% of families
85%

Share of the \$3.1 trillion increase in stock market holdings by U.S. households between 1989 and 1997. Includes all shares owned by households, directly and indirectly. Holdings in 1989 were stated in 1997 dollars.

DATA: EDWARD N. WOLFF, NEW YORK UNIVERSITY

own stock worth more than \$5,000, Wolff finds.

Or take the middle fifth of households. Their average stock holdings, when adjusted for inflation, have doubled—but from only \$4,000 in 1989 to just \$8,000 in 1997. And those in the bottom 40% of households owned only \$1,600, says Wolff.

As a result, most of the benefits of the 1990s bull market have bypassed average Americans. At the end of 1997, U.S. households owned \$5.9 trillion worth of stock, giving them an inflation-adjusted gain of \$3.1 trillion since 1989, Wolff concludes. But because

middle-class America's stock holding still amount to so little, the richest 1% of households received 42.5% of the \$3.1 trillion (chart). The next wealthiest 9% acquired 43%, leaving the bottom 90% of households to divide less than 15%. The bottom 40% received just 1% of the total. "There were many newcomers to the stock market in the 1990s, but their holdings are still relatively small," says James M. Poterba, an economist at Massachusetts Institute of Technology who also has done studies of stock ownership.

DEBT FACTOR. In fact, the total net worth of average Americans hasn't budged since 1989, despite the bull market. The reason: Most families have taken on additional debt, and that outweighs any stock gains. In 1997, the middle fifth of households had a net worth—assets less debts—of \$56,000, down from \$58,000 in 1989, after adjusting for inflation, Wolff found.



Rest of Country
15%

The same pattern held even for the 10% of families just under the wealthiest 10%. Their stock holdings averaged \$35,000 in 1997, a 40% gain from 1989. But their net worth nonetheless slipped by 6%, adjusted for inflation.

The good news in all this, of course, is that even a further slump in stocks will not directly hurt most families very much. Without question, homes, not stocks, remain by far the biggest financial asset for most American families. So today's complacency about inflation and low interest rates are much more important than

the stock market to their spending power, points out EPI economist John Schmitt, who helped Wolff analyze the data on wealth.

Many middle-class Americans are still salting away plenty of money into stock through 401(k)s and other funds. Since a lot of this investment involves long-term savings for retirement, even more bad news from the market probably won't stop the slow spread of stock ownership. But given the still small stake that most Americans have today, true democratization of the market remains many years away.

By Aaron Bernstein in Washington

Netscape

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BY GENE G. MARCIAL

SEEKING SAFETY FROM THE STORM

Weeks before the Dow plummeted 512 points on Aug. 31, investment manager Bill Priest was already well on the way to completely bailing out of what he calls "elite super stocks" such as Coca-Cola, Gillette, and Aetna. "We've been cautious for some time, but mainly toward the S&P 500's top 50 blue chips," says Priest, CEO of BEA



PRIEST: Bailed out of blue chips

Associates, a unit of Credit Suisse Asset Management, which manages some \$36 billion.

So where is Priest putting the cash from the sale of the mega stocks? Into the mid to lower tier of the S&P 500, stocks with market caps of \$1.5 billion to \$20 billion. His top three choices: AMR (AMR), parent of American Airlines; COMSAT (CQ), a major provider of satellite and technology services; and Gannett (GCI), a leading newspaper publisher that also owns TV and radio stations.

BEA measures a company's value, in part, by how much excess cash flow is available—after deducting the cost of keeping up with capital expenses from operating earnings and debt—to pursue plans to maximize shareholder value, such as stock buybacks and acquisitions. Shares of AMR, COMSAT, and Gannett are all undervalued based on this method, says Priest.

AMR, which traded as high as 89 a share in mid-July, is down to 55, in part due to worries over Asia. But AMR isn't significantly dependent on the Asian market, and its European business is thriving. Trading at about 5 times operating earnings, "the stock is really cheap," says Priest, based on its growth rate. He expects AMR, which has dipped to 52% on Sept. 2, to hit 90 in a year.

COMSAT, a provider of satellite capacity to U.S.-based telecoms, will benefit from the rapidly growing long-distance market worldwide, notes Priest. Its clients include AT&T, MCI, and

Sprint. The stock, which tumbled to 26 on Aug. 31 from 42 in late April, should climb to the mid-40s, he says. On Sept. 2, the stock rallied to 29%.

Gannett should be another winner, argues Priest, because of its predictable, stable earnings growth. Shares of the publisher of 88 daily newspapers, including *USA Today*, should rebound to the 75-80 level, predicts Priest, from its current price of 57¹⁵/₁₆; it was 75 in early April.

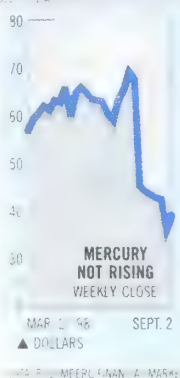
HONK IF YOU LIKE MERCURY GENERAL

Ed Walczak, U.S. investment chief for German bank Vontobel, which steers \$2 billion in the U.S., was one of those who cheered the market's plunge. The unexpectedly big fall gave him the opportunity to bargain-buy one of his chief favorites: Mercury General (MCY), a large auto insurer in California.

Why is he hot on Mercury? Walczak, a Warren Buffett disciple, thinks Mercury is another GEICO, a low-cost insurer that Buffett recently acquired. "Mercury General is a Buffett-type stock, with insiders owning a big stake in the company," notes Walczak. The company, a low-cost auto insurer that sells through outside agents, has benefited from a new California law requiring motor vehicle insurance. Mercury has buyout appeal, says Walczak. "It won't be illogical if Commerce Group, a large auto insurer in Massachusetts, seeks to buy Mercury in order to expand in California," says Walczak. Two years ago, Commerce Group was rumored to be interested in Mercury. Other possible buyers: GEICO and American Insurance Group, says Walczak. In a buyout, he figures the stock is worth 73.

Shares of Mercury had been in a downdraft even before the Dow's big drop, sinking from 69 on July 13 to 43 in just a month. There was concern about earnings momentum over the next several quarters. Walczak thinks the selling was unjustified. When the

DOWN BEFORE THE DOW'S DROP



Dow crashed on Aug. 31, it skidded some more, to 36. By Sept. 2, it had risen to 39%. He expects earnings of \$3.45 in 1998 and \$3.60 in 1999.

A CHANCE TO BUY AT THE BOTTOM?

One of Wall Street's veteran market gurus, Seth Glickenhau, thinks the selling in the market isn't over. "There's still some room on the downside, with more bad innings possible—but we're nearing bottom," he says. So what's Glickenhau's strategy?

"We're buying heavily, but selectively—some of the ones we have always liked and some new names that have become attractively priced," he says.



GLICKENHAUS: He likes Merrill

Glickenhau runs a New York investment firm bearing his name, which manages more than \$5.5 billion. Among the stocks Glickenhau thinks have become compelling buys: Merrill Lynch (MER), which dove 7%, to 66, on Aug. 31—way off its high of 107 on July 13; Chrysler (C), which skidded 4¹⁵/₁₆, to 45%, down from 61 on July 24; and homebuilder Lennar (LEN), which fell 5%, to 18%—a far cry from its of 36¹⁵/₁₆ on Apr. 20.

Glickenhau notes that for people betting on the market, Merrill is the play. It has a large in-house mutual-fund operation, with \$448 billion in assets under management. The stock rose to 67¹⁵/₁₆ by Sept. 2.

As for Chrysler, "it's a win-win situation" because of its merger with Daimler-Benz, he says. Glickenhau figures that if the deal flies, investors will own 47% of a more robust Daimler-Chrysler. If the deal collapses, Chrysler would still be worth more than its current price, says Glickenhau. The stock inched up to 49¹⁵/₁₆ on Sept. 2.

Lennar, says Glickenhau, is benefiting from the surge in homebuilding. On Sept 2, the stock rose to 19%.

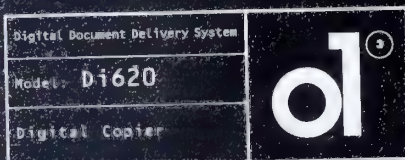
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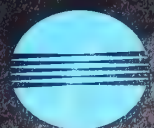
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MINOLTA

EDITED BY AMY DUNKIN

The Big Apple's Inn Places to Dine

The whole world seems to be in a New York state of mind—and why not? Crime is way down and the city is in great economic shape. The streets crackle with an energy that makes Rudy Giuliani the envy of big city mayors around the world.

To accommodate the full pockets of New Yorkers and out-of-towners alike, restaurateurs and hoteliers are opening places at a feverish pace. That's fortunate, as the city's

81% hotel occupancy rate makes it difficult for visitors to find a bed. Moreover, hoteliers, seeking to stem the flow of hungry guests out of their establishments to eat, are tapping world-class chefs to run their kitchens. You can get four-star chefs cooking your dinner and breakfast without leaving your hotel.

Take the Mercer Hotel. Located in trendy Soho in a building that more than 100 years ago housed the offices of John Jacob Astor, the Mercer features front-desk staffers and bellhops that look like they've jumped out of a Calvin Klein ad. That's only fitting, because Klein himself has been in residence since the hotel opened three months ago.

The spacious rooms, priced from \$325 to \$430, are symphonies in brown that feature cordless telephones and backlit closets. Owner Andre Balasz, whose other hotels include the Chateau Marmont and the soon-to-be-opened Standard in Los Angeles, has recruited the talented chef Jean

Georges Vongerichten. The restaurant he runs is called the Mercer Kitchen, a surprisingly warm and comfortable dining room located in the hotel's basement. It's also shockingly affordable, considering the quality of the food—two people can easily eat for less than \$100 including wine. Diners sitting in full view of the open kitchen will notice a whirl of cooking activity, lots of copper pots, a wood-burning oven, and spices in long, tall canisters that look like edible art.

Vongerichten's food at the Mercer is simple, flavorful, and inventive. He shows off his Alsatian roots with a pizza-like tarte flambé with tart fromage blanc, onions, and bacon. More unusual is the rotisserie free-range chicken with olive vanilla sauce, yogurt, and cucumber. His molten chocolate cake with caramel ice cream is a fitting dessert in a hotel decked out in more shades of brown than any-
one knew existed.



Vongerichten is also running the culinary show in the Trump International Hotel & Tower on Columbus Circle. A room will set you back anywhere from \$395 to \$800 a night—and even that doesn't guarantee you a view of Central Park.

While the lunch and dinner menus at the eponymous Jean Georges and the more informal Nougatine have been justly celebrated, equally special is the breakfast at Nougatine. Don't come here for scrambled eggs and toast. Splurge for the decadent shirred eggs with house-smoked salmon, or, in season, the poached eggs with freshly shaved truffles with potato pancakes. If you have a sweet tooth,





THE HIP AND HUNGRY: At Soho's chic Mercer Hotel (low), chef Vongerichten's new place is warm and comfy; at left, lemongrass risotto at City Wine & Cigar.

ou may want to go for the french toast with caramelized apples.

Ian Schraeger, an original partner at the Studio 54 iscotheque who now operates some of New York's rendiest hostelrys, installed the contemporary Chinese-latin restaurant Asia De Cuba a year ago in his Philippe Starck-designed Morgans Hotel (smallish rooms from \$275 to \$300). It has been packed Studio 54-style ever since with scenemakers, wannabes, and foodies who have come to sample the intriguing dishes chef Robert Trainor serves.

Appetizers and desserts far outshine the entrées here, and the appetizer portions fortunately are so big that you can head straight from starters to sweets. One must-have dish is the Chinese roast pork-adillo pancakes with sour orange and ginger cream.

Some of the city's more staid and established hotels have enticed major chefs to head their kitchens. The Stanhope, located across the street from the Metropolitan Museum of Art, contracted with the superb young chef Matthew Kenney to run Café M, a part-

ner in the venture with hotelier Balasz, put the stellar Jeremy Griffiths in charge of the stoves, and the resulting cuisine has been simple, flavorful, and just creative enough. The one outstanding entrée is the charcoal-grilled lamb chops with olive mashed potatoes with braised fennel. But try to save some room for the orange panna cotta with caramelized figs for dessert.

UPSCALE PIZZAS. If you're staying at the Stanhope and want to stroll to some tony Upper East Side dining spot nearby, head to either the Lobster Club (24 E. 80th St., 212 249-6500) or Butterfield 81 (170 E. 81st St., 212 288-2700). The Lobster Club's two-story dining room is a cheerful setting for Anne Rosenzweig's clever take on contemporary American cuisine. At Butterfield 81, Tom Valenti turns out fabulous, earthy, French-influenced fare. (Don't miss the lamb shank or the sturgeon chickpea pancake appetizer).

Not far away sits the Boathouse in Central Park, a few blocks south and west of the Met. Food lovers used to regard the Boathouse with disdain. Now they're flocking there. At 26, *wunderkind* chef John Villa turns out food that finally matches the magical view of the rowboat pond and Bethesda Fountain. Don't miss his rice-paper roll appetizer or seared tuna with coriander.

If you're on a shopping spree, you can eat well, too. For example, Mitchel London, chef for Ed Koch when he was mayor, is in charge of the food at the quirky Parlour Cafe (38 E. 19th St., 212 677-2233) in the ABC Carpet and Home store. He serves up world-class pancakes, a melt-in-your-mouth *croque monsieur*, and the city's best chocolate cupcakes as diners ogle exotic housewares and furniture

from around the world. At Fred's at Barney's (10 E. 61st St., 212 833-2200), Mark Straussman turns out *frites* and designer pizzas to die for, including one made with Robiola cheese and truffle oil.

Even museums are getting into the haute-cuisine act. Until the Museum of Modern Art brought in restaurateur Nino Esposito, it was difficult to get a good meal at a museum in New York. Now, at Sette MOMA (11 W. 53rd St., 212 708-9710), you can enjoy simple but satisfying Italian fare such as pasta with asparagus tips, oyster mushrooms, and shaved black truffles while overlooking the museum's spectacular sculpture garden.

The newcomer Italophiles are most excited about is Greenwich Village's Babbo (110 Waverly Place, 212 777-0303), located in a beautiful

Hotels Where The Food Is Divine

MERCER HOTEL

99 Prince St.
212 966-6060

MERCER KITCHEN

212 966-5454

MORGANS HOTEL

237 Madison Ave.
212 686-0300

ASIA DE CUBA

212 726-7755

STANHOPE HOTEL

995 Fifth Ave.
212 288-5800

CAFE M

212 717-0303

TRUMP INTERNATIONAL HOTEL

1 Central Park West
212 299-1000

JEAN GEORGES

212 299-3900

brownstone that housed the legendary Manhattan restaurant the Coach House. Babbo (Italian slang for Daddy) is owned by proud papas Joe Bastianich (proprietor of the fine theater-district restaurants Frico Bar and Becco) and Mario Batali (of the Food Network's *Molto Mario* show and the restaurant Po). Bastianich supervises the inventive wine program that encourages tasting by offering *quartinos* (thirds of bottles), while Batali, along with *chef de cuisine* Andy Nusser, turns out marvelously inventive dishes

such as beef-cheek ravioli with crushed squab livers and summer truffles and a dry-rubbed ribeye steak with roasted potatoes, garlic greens, and salsa verde. Don't pass up the chocolate pistachio semifreddo and the creamiest, most intensely flavored ice creams this side of Rome.

STILL COOKING. Further downtown, in the shadow of the World Trade Center, is the City Wine & Cigar Co. (62 Laight St., 212 334-2274). There, former Joffrey Ballet dancer Patricia Williams is turning out dishes such as braised short

ribs that can stand up to the stogies being puffed on by the likes of regulars Robert de Niro and Harvey Keitel.

Don't look for the new restaurant and hotel activity to slow down in the near future. Architect-designer David Rockwell and restaurateur Drew Nieporent, the force behind the always-busy Nobu downtown, are combining their talents at WNew York and its restaurant Heartbeat in the former Doral Hotel at 51st Street and Lexington Avenue. It's scheduled to open in November. Four-star chef

Daniel Boulud is unveiling Cafe Boulud in late September, in the Surrey Hotel space that formerly housed Restaurant Daniel at 76th Street between Madison and Fifth Avenues. Boulud is spending millions to build the new Daniel, which will open in January in the old Le Cirque space in the Mayfair Hotel (now a co-op building).

It's the ultimate game of restaurant-hotel Can You Top This?, and how far it will go is anyone's guess. But New York's visitors and gastronomes can't help but come out winners. *Ed Levine*

It Ain't Elegant, But...

NEW YORK STILL LEADS THE WORLD IN GREAT ETHNIC FOOD

Certain eating experiences are mandatory for all residents and visitors to New York. No reservations or credit cards are needed—just a hearty appetite.

If deli is to your liking, visit the Lower East Side. Katz's (205 East Houston St., 212 254-2246) has been hand-slicing its peppery and garlicky pastrami for sandwiches for 110 years. Give the counterwoman a buck with your self-service ticket to further fatten an already huge sandwich.

Nearby, Mark Federman, a lawyer turned lox maven, presides over Russ & Daughters (179 East Houston St., 212 475-4880), a takeout business his grandfather started 88 years ago from a

pushcart. Ask for a bagel and lox that's made with delicately smoked, satiny Gaspé salmon.

For pizza perfection, drop by Lombardi's in SoHo (32 Spring St., 212 941-7994). More than a century after Gennaro Lombardi introduced pizza to Americans at his tiny store, his grandson, Gerry, and his partner, John Brescio, still turn out fabulous, coal-fired, brick-oven pies at an atmospheric location across the street from Gennaro's original site. Ask

for a clam pie with fresh-shucked clams, garlic, and romano cheese. For a completely different ethnic experience, New Yorkers flock to Joe's Shanghai for soup dumplings. Joe's restaurants in both Chinatowns—Flushing, Queens (136-21 37th

Ave., 718 539-3838) and lower Manhattan (9 Pell St., 212 233-8888)—feature baskets of delicious pork-and-crab soup-filled dumplings, which explode with flavor—and the soup—when you bite into them.

New York is also the street food capital of America. You'll find Johannes Sanzin turning out world-class soups for Wall Street titans and office workers in his storefront at 77 Pearl St. (212 269-5777). Try his chicken soup with lemon-grass and mint (\$5.95 for a regular container). And don't overlook the falafel at Moshe's, whose huge cart infuses the corner of 46th



A LA CART: From falafel to pizza, you can get comfort food in a New York minute

Street and Avenue of the Americas with the smell of frying chickpeas. Moshe enlivens his falafel with cumin, stuffing it into a fresh pita with creamy tahini and Middle Eastern pickles.

For those with a sweet tooth, the flaky, buttery cylinders of rugelach at Margaret Palca Bakes in



Carroll Gardens, an Italian neighborhood near the mouth of the Brooklyn Battery Tunnel (193 Columbia St., 718 802-9771), are sublime. And Maury Rubin's tarts at City Bakery (22 East 17th St.,

212 366-1414) resemble Mondrian paintings—and taste even better than they look. Sample the Milky Way or crème brûlée tart. And just try to resist the real frozen custard at Custard Beach (33 East 8th St., 212 420-6039), made with egg yolks and plenty of butterfat. You may find yourself exclaiming—as one ice cream executive did—that “this is where God goes to get his ice cream.” *Ed Levine*



Monti: Where Roman Armies Kicked Back

THE CITY'S OLDEST QUARTER IS NOW ITS MOST CHARMING

Essential stops on any Roman holiday are the Colosseum and the Forum. But rarely do visitors venture to the narrow cobblestone streets of the neighborhood sandwiched between the two landmarks. In ancient

times it was known as the *Subura*, or eat shum, home to prostitutes, *psies*, and thieves, and the



place Julius Caesar sent his troops to unwind after battle. More than 2,000 years later, despite the area's gentrification, Italian police still find the illegal brothels tucked away there. Now called Rione Monti, Rome's oldest quarter is regarded by many as the most authentic and tourist-free district in the modern city.

In the square-mile neighborhood of Monti, you're likely to see snippets of Italian living from a bygone era. Residents of top-floor apartments, reluctant to climb three or four flights in the heat, let down wicker baskets from their windows by ropes and yell down to nearby shopkeepers to fill them. Once a month, a man circles the streets with a tiny motorized cart to sharpen dull cutlery and fix broken umbrellas.

Despite its location at the city's center, Monti is a safe island of tranquility. You can wander through the vi-

coletti, or alleys, and examine architectural treasures without the traffic and noise in much of Rome. Buildings on the tiny Via degli Ibernesi on Monti's southwestern edge represent a cross section of architectural history. For centuries, residents have added floors to existing structures. You might see a medieval palazzo built on ancient Roman foundations, with a third floor from the Renaissance and a 1950s' concrete roof terrace.

A woman I know owns a house near the Forum that has columns from a Roman temple in the basement. In fact, Monti is built on top of scores of unexcavated Roman-era temples and monuments, and smugglers and bandits are said to have created a network of secret passages through this netherworld. Over the summer, archaeologists began uncovering ancient Roman treasures in the part of Monti that borders Rome's main square, Piazza Venezia.

FORTRESSES. In the Dark Ages, the warring families of the city built fortified towers to show their wealth. By the end of the 13th century, Rome had 200 such towers. Today, only about a dozen remain—five in Monti. The most famous, the seven-story, brick La Torre delle Milizie, was built 800 years ago as part of a fortress by Pope Gregory IX.

Many of Monti's street names reveal secrets from its past. Piazza degli Zingari



BYGONE ERA: Residents of the square-mile neighborhood still yell down to shopkeepers for their provisions

(Gypsy Square) is built on the site of a medieval nomad encampment. The Vicolo delle Carrette (Carriage Alley) is named for the area of Renaissance Rome where horse-drawn carriages brought barrels of white wine from the Castelli Romani grape-growing region 20 miles away. As you stroll these byways, it will be hard to miss the aroma of traditional Italian cooking. On the main street, Via dei Serpenti, the Pasticceria La Licata makes a fabulous ricotta cheesecake and an unforgettable honey pastry said to come from an ancient Roman recipe. On Via Madonna dei Monti, Pizze-

ria Le Carrette has perhaps the city's finest pizza and exemplary antipasti such as fried olives stuffed with meat (*olive oscolane*).

Before World War II, Benito Mussolini tore down part of residential Monti to build the broad avenue called Via dei Fori Imperiali, which connects the Colosseum to Piazza Venezia. He thought the avenue would move Rome toward modernity, but the construction destroyed about 30% of the neighborhood. Despite this wound, the district has maintained its flavor and today attracts people looking for affordable homes in a unique neighborhood. With relics from Julius Caesar to more modern times, Monti is one more reminder of Rome's eternal character. *Monica Lerner*

TRAVEL TIP

► *Pasticceria La Licata on Via dei Serpenti makes honey pastries said to be based on an ancient Roman recipe*

Winging Around Europe—Cheaply

WITH A DISCOUNT CARRIER, THAT \$800 FARE CAN BE \$80

Not long ago, I needed to fly one-way from Brussels to Barcelona. "We don't have one-way fares," snapped a salesman for Belgium's national airline, Sabena. For the 75-minute flight, he proposed a \$400 round-trip ticket that required a Saturday night stay. A midweek round-trip? \$800. So I called Virgin Express, Richard Branson's discount carrier. One way? No problem. How much? \$80—and no restrictions. That was more like it.

Since Europe deregulated its airlines last year, a slew of low-cost carriers have followed the example of Southwest Airlines and other U.S. discounters and have taken aim at high-fare national carriers (table). Want to go from London to Edinburgh? On Britain's easyJet, fares start at \$30. Indeed, the European Commission says deregulation has brought down 80% of Europe's air fares.

Most of the cheap carriers are targeting leisure travelers. But they are also getting increasing business from corporate road warriors. EasyJet, for example, offers flights in early morning and late afternoon, when competitors' fares tend to be highest.

Whether you're considering discount tickets for business or vaca-

tion, be aware that some drawbacks remain. Most low-fare carriers are based in Britain and fly to southern Europe. But be sure to ask where you'll take off and land, as many carriers use less convenient secondary airports. EasyJet has its hub at London's Luton Airport, which is 30 miles north of the British

capital and an hour by bus to Heathrow or train to Gatwick. Go—British Airways' discount—and Virgin Express use Rome's Ciampino airport, which has no trains, few taxis, and poor bus connections to the Italian capital. And when Ireland's Ryanair flies to Brussels, its planes land in Charleroi, 30 miles south of the Belgian capital. The 45-minute cab ride into town will set you back \$125. The use of alternative airports makes it difficult to make connections with transatlantic lines, and you could be stranded if your flight is delayed or canceled.

"Low cost" can also mean different things. EasyJet, Ryanair, and Virgin Express do the bulk of their business through telephone sales or the Internet. Most travel agents in the U.S. don't sell their tickets, so a Web site visit or call to Europe may be required to make a reservation. Once you get to the airport, there are no seating assign-

ments—and forget about free meals and roomy business-class seats. But other startups, such as AB Airlines, Debonair, and KLM UK, offer travel agent ticketing, seat assignments, meals, and even business class. Ian Hawkes, AB's marketing director, says his airline's "business class is comparable to British Airways", with newspapers and even champagne." AB's round-trip business-class fare between Berlin and Nice starts at around \$600, compared with \$775 for British Airways.

DOGFIGHT. Traditional airlines are fighting back to meet the competition. Lufthansa, Iberia, Alitalia, and KLM have started offering bargain excursion fares. After easyJet began flying from London to Amsterdam for \$45, for example, KLM quickly matched the fare. But the discounters are expanding rapidly. Ryanair has ordered 25 Boeing 737s, Virgin Express has another four 737s on order, and Germany's Eurowings is replacing its turboprops with jets and building a European network.

As in the U.S., some of the startups could eventually fold. In the meantime, though, I intend to make the best of it. My Virgin Express flight to Barcelona went smoothly. The plane was clean and comfortable, and the cabin staff smiled. A free Coke refreshed me, and I didn't worry much about the missed airline meal. I arrived on time for a dinner far superior to anything I'd get even in the most costly carrier's first-class seat. *William Echikson*



GETTING THERE

VIRGIN EXPRESS: Smiles and Cokes



The Eurostartups

AIRLINE	PHONE*	WEB SITE	HOME
AB	44 1849-453-312	www.abairlines.com	London (Stanstead)
AIR ONE	39 1478-48880	www.flyairone.it	Milan (Linate)
DEBONAIR	44 541-500-300	www.debonair.co.uk	London (Luton)
EASYJET	44 990-292-929	www.easyjet.com	London (Luton)
EUROWINGS	49 231-9245-333	www.eurowings.de	Nuremberg
GO	44 845-805-4321	www.go-fly.com	London (Stanstead)
KLM UK	44 990-074-074	www.klmuk.com	London (Stanstead)
RYANAIR	353 1-809-7991	www.ryanair.ie	Dublin
VIRGIN EXPRESS	32 2-752-0505	www.virgin-express.com	Brussels

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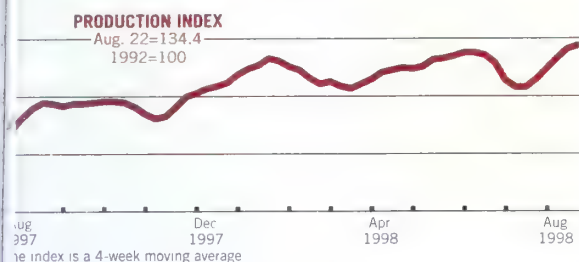
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PRODUCTION INDEX

Change from last week: 0.2%
Change from last year: 3.8%



The production index continued to rise in the week ended Aug. 22, while the averaged index fell 0.5%, to 134.8, from 135.5. After seasonal adjustment, rail-traffic was up 0.6%, with sharp increases in automotive traffic and loadings of stone, sand, and gravel. Output of steel and oil were also up. Production of autos, trucks, coal, and lumber were down. Electric power also fell with decreases in the available amounts of energy in the New England and Pacific Northwest areas.

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ADING INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STOCK PRICES (8/28) S&P 500	1027.40	1081.18	14.2
CORPORATE BOND YIELD, Aaa (8/28)	6.52%	6.50%	-10.1
KEY SUPPLY, M2 (8/17) billions	\$4,233.3	\$4,230.7r	7.1
UNEMPLOYMENT CLAIMS, UNEMPLOYMENT (8/21) thous.	297	303r	-8.3
MORTGAGE APPLICATIONS, PURCHASE (8/28)	269.4	243.1	30.9
MORTGAGE APPLICATIONS, REFINANCE (8/28)	1,331.5	1,211.9	379.3

Sources: Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Bankers Assn. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
FEDERAL FUNDS (9/1)	5.75%	5.50%	6.23%
COMMERCIAL PAPER (9/1) 3-month	5.44	5.49	5.52
CERTIFICATES OF DEPOSIT (9/2) 3-month	5.52	5.57	5.60
FIXED RATE MORTGAGE (8/28) 30-year	7.02	7.02	7.72
ADJUSTABLE MORTGAGE (8/28) one-year	5.72	5.75	5.73
LIBOR (9/2)	8.50	8.50	8.50

Sources: Federal Reserve, HSH Associates, Bloomberg Financial Markets

Raw data in the production indicators are seasonally adjusted in computing the BW index (chart); other components (estimated and not listed) include machinery and defense equipment. 1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

THE WEEK AHEAD

TALLMENT CREDIT

Friday, Sept. 8, 3 p.m. EDT ▶ Consumers have added only about \$3 billion in new debt in July, says the median forecast of economists surveyed by Standard & Poor's, a unit of The McGraw-Hill Companies. Debt had risen by a large \$6.7 billion in June, but in general, installment debt increases have slowed this year. Consumers are finding new borrowing avenues, such as home equity loans.

EMPLOYMENT CLAIMS

Thursday, Sept. 10, 8:30 a.m. EDT ▶ New claims for state unemployment benefits likely to be about 310,000 for the week ended Sept. 5. Filings had fallen to just 297,000 in

the week ended Aug. 22, the first time since mid-April that claims dropped below 300,000. Economists will be watching jobless filings for any hint that labor markets are loosening.

CURRENT ACCOUNT BALANCE

Thursday, Sept. 10, 10 a.m. EDT ▶ The current account deficit—a type of cash-flow statement of U.S. international business, including trade in goods and services, net investment income, and foreign transfers—likely rose to at least \$50 billion in the second quarter, from \$47.2 billion in the first quarter, and only \$35 billion a year earlier. The widening is suggested by the steep deterioration in the merchandise trade gap. At

\$52 billion, the current account deficit would equal 2.5% of the economy, the highest ratio since 1988. A 3% mark is usually when questions arise about a nation's ability to finance its international obligations and its currency begins to weaken.

PRODUCER PRICE INDEX

Friday, Sept. 11, 8:30 a.m. EDT ▶ The S&P MMS survey projects that producer prices for all finished goods were likely unchanged in August, after increasing 0.2% in July. Excluding food and energy items, prices probably edged up only 0.1% last month, the same small gain posted in July. The steep drop in import prices is holding down overall goods inflation.

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (8/29) thous. of net tons	2,040	2,127#	-5.1
AUTOS (8/29) units	126,544	119,127r#	12.8
TRUCKS (8/29) units	138,391	128,631r#	13.4
ELECTRIC POWER (8/29) millions of kilowatt-hrs.	80,335	76,283#	12.9
CRUDE-OIL REFINING (8/29) thous. of bbl./day	15,688	15,577#	1.8
COAL (8/22) thous. of net tons	21,973#	21,840	4.0
LUMBER (8/22) millions of ft.	493.4#	489.7	2.1
RAIL FREIGHT (8/22) billions of ton-miles	27.3#	26.9	3.4

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WPAI, SFPa2, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (9/2) \$/troy oz.	280.150	283.150	-12.9
STEEL SCRAP (9/1) #1 heavy, \$/ton	120.50	120.50	-17.7
COPPER (8/28) ¢/lb.	77.4	77.0	-24.3
ALUMINUM (8/28) ¢/lb.	64.5	63.8	-18.9
COTTON (8/29) strict low middling 1-1/16 in., ¢/lb.	72.81	73.19	3.2
OIL (9/1) \$/bbl.	13.67	13.81	-29.4
CRB FOODSTUFFS (9/1) 1967=100	213.55	220.77	-10.8
CRB RAW INDUSTRIALS (9/1) 1967=100	283.33	287.47	-29.1

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (9/2)	137.70	144.53	121.16
GERMAN MARK (9/2)	1.75	1.81	1.82
BRITISH POUND (9/2)	1.67	1.64	1.59
FRENCH FRANC (9/2)	5.88	6.06	6.11
ITALIAN LIRA (9/2)	1732.0	1782.5	1773.5
CANADIAN DOLLAR (9/2)	1.54	1.56	1.38
MEXICAN PESO (9/2)	9.965	9.810	7.766
TRADE-WEIGHTED DOLLAR INDEX (9/2)	113.4	116.9	107.1

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan

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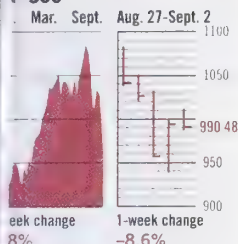
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Investment Figures of the Week

STOCKS

P 500



COMMENTARY

Rule. No one escaped the market mauling. In a rout triggered by the Russian financial economic crisis, the Dow Jones industrials lost nearly 1000 points between Aug. 26 and Aug. 27, dropping to 7539. The Dow bounced back to 7827 on Sept. 1, but after two failed attempts to pierce the 7950 barrier on Sept. 2, stocks plunged to close at 7782. For the week, the Dow lost 1.87% and wiped out 3 weeks' gain. The S&P 500, still in the black for the year, lost 0.6%. One bright spot: Investors bought Treasury bonds and bills, pushing interest rates down.

U.S. MARKETS

	Latest	% change Week	% change Year
Dow Jones Industrials	7782.4	-8.7	-1.4
NASDAQ Combined Composite	1592.9	-9.9	-1.6
S&P MidCap 400	293.9	-7.8	-8.1
S&P SmallCap 600	148.4	-7.6	-16.9
S&P SuperComposite 1500	208.4	-8.6	4.2

SECTORS

	Latest	% change Week	% change Year
Bloomberg Information Age	326.2	-9.0	10.8
S&P Financials	109.7	-9.8	2.6
S&P Utilities	232.3	-3.3	15.2
PSE Technology	300.3	-10.5	-9.6

FOREIGN MARKETS

	Latest	% change Week	% change Year
London (FT-SE 100)	5235.8	-5.6	5.2
Frankfurt (DAX)	4970.5	-5.0	21.1
Tokyo (NIKKEI 225)	14,376.6	-3.3	-23.3
Hong Kong (Hang Seng)	7355.7	-6.1	-50.0
Toronto (TSE 300)	5682.5	-7.9	-15.2
Mexico City (IPC)	3178.6	-2.3	-35.0

FUNDAMENTALS

	Latest	Week ago	Year ago
S&P 500 Dividend Yield	1.58%	1.44%	1.63%
S&P 500 P/E Ratio (Last 12 mos.)	22.8	26.4	23.5
S&P 500 P/E Ratio (Next 12 mos.)*	24.4	24.4	18.5
First Call Earnings Revision*	-3.78%	-3.26%	-0.87%

TECHNICAL INDICATORS

	Latest	Week ago	Reading
S&P 500 200-day average	1059.9	1057.3	Negative
Stocks above 200-day average	15.0%	26.0%	Positive
Options: Put/call ratio	0.81	0.66	Positive
Insiders: Vickers Sell/buy ratio	1.03	1.09	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Food Chains	6.2	Broadcasting 62.3
Electric Companies	3.8	Drug Chains 50.6
Drug Chains	-2.5	Long-Dist. Telecomms. 45.3
Tobacco	-3.1	Drugs 44.8
Specialty Chemicals	-3.7	Communications Equip. 41.4

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
HMOs	-37.7	Metals -56.2
Invest. Banking/Bkrge.	-29.5	Oil & Gas Drilling -56.1
Shoes	-28.5	Gold Mining -47.7
Money Center Banks	-26.7	Oil Exploration & Prod. -45.6
Metal & Glass Containers	-25.2	Shoes -45.6

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness

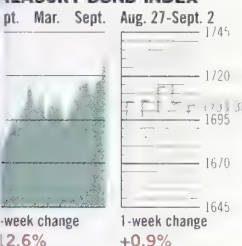
	Price	1-month change
Intel	76	-8 13/16
Citicorp	106 5/8	-57
America Online	85	-31
IBM	117 15/16	-14 13/16
General Electric	82 1/16	-6 13/16
BankAmerica	64 1/2	-24 3/16

Decline ahead? Stocks with most significant selling on price strength

	Price	1-month change
Home Depot	41 1/4	5/16
Conagra	26 3/8	3/8
Phillips Petroleum	43 11/16	3/4
Albertson's	50 3/8	1 7/8
Adaptec	11 1/2	1/2
GPU	37 1/8	3/4

INTEREST RATES

TREASURY BOND INDEX



KEY RATES

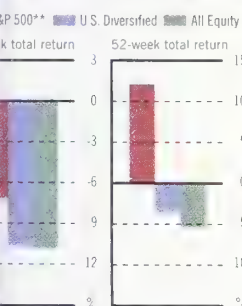
	Latest week %	Week ago %	Year ago %
MONEY MARKET FUNDS	5.11	5.10	5.16
90-DAY TREASURY BILLS	4.88	5.06	5.14
6-MONTH BANK CDS	5.05	5.06	5.17
1-YEAR TREASURY BILLS	4.90	5.16	5.57
10-YEAR TREASURY NOTES	5.07	5.26	6.33
30-YEAR TREASURY BONDS	5.33	5.44	6.60
LONG-TERM AA INDUSTRIALS	6.28	6.21	7.10
LONG-TERM BBB INDUSTRIALS	6.88	6.69	7.47
LONG-TERM AA TELEPHONES	6.65	6.55	7.36

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond Latest week	10-yr. bond Last week	30-yr. bond Latest week	30-yr. bond Last week
GENERAL OBLIGATIONS	4.24%	4.27%	4.88%	4.86%
PERCENT OF TREASURIES	83.60	82.12	91.42	89.66
TAXABLE EQUIVALENT	6.14	6.19	7.07	7.04
INSURED REVENUE BONDS	4.42	4.44	5.05	5.06
PERCENT OF TREASURIES	87.15	85.39	94.61	93.35
TAXABLE EQUIVALENT	6.41	6.43	7.32	7.33

MUTUAL FUNDS



EQUITY FUNDS

Leaders

Four-week total return	%	Laggards	%
Prudent Bear	21.2	Lexington Troika Russia	-60.4
ProFunds UltraBear Investor	11.9	Vontobel Eastern Europ. Eq.	-41.1
Comstock Part. Cap. Val. R	9.6	American Heritage	-40.5
Comstock Part. Strategy D	6.9	Invesco Latin American Gr.	-38.1
Rydex Urca	6.6	Excelsior Latin America	-36.5

Leaders

52-week total return	%	Laggards	%
Smith Barney Telecomms. Inc.	45.8	Lexington Troika Russia	-87.3
Weitz Hickory	39.9	Guinness Flgt. Asia Sm. Cap	-71.4
Icon Telecomms. & Utilities	35.8	U.S. Global Inv. China Reg.	-69.6
Caldwell & Orkin Mkt. Opp.	32.6	Montgomery Emerg. Asia R	-69.2
Flag Investors Commun. A	32.5	Lex. Crosby Sm. Cap Asia	-68.9

EQUITY FUND CATEGORIES

Leaders

Four-week total return	%	Laggards	%
Utilities	-3.5	Latin America	-30.4
Japan	-5.0	Diversified Emerging Mkts.	-25.0
Domestic Hybrid	-5.2	Precious Metals	-17.8
International Hybrid	-5.6	Small-cap Growth	-15.5
Real Estate	-7.2	Small-cap Blend	-15.1

Leaders

52-week total return	%	Laggards	%
Utilities	17.5	Pacific/Asia ex-Japan	-55.0
Communications	13.9	Precious Metals	-49.5
Europe	12.7	Latin America	-46.5
Large-cap Growth	8.9	Diversified Emerging Mkts.	-45.9
Large-cap Blend	6.0	Diversified Pacific/Asia	-41.1

Data are as of market close Wednesday, Sept. 2, 1998, unless otherwise indicated. Industry figures include S&P 500 companies only. Fundamentals, technical indicators, Bloomberg money flow analysis, and mutual fund returns are as of Sept. 1. For a more detailed explanation, write to us or E-mail figures@businessweek.com. NA=Not available. **Vanguard Index 500 Fund

REMEDIES FOR THE GLOBAL CRISIS

Economic history offers many cautionary episodes, but none quite so striking as the one pictured here: Beginning in 1929, the value of world trade started to contract until, four years later, it amounted to a mere one-third of what it had been. An unlucky constellation of global events—deflation in commodity prices, the October stock market crash, and bank failures in the U.S. and Europe—had set the global economy on its downward course. But it was a series of policy mistakes—too-tight money, competitive devaluations, new and onerous tariff barriers—that plunged the world into depression and made the struggle for recovery so long and painful. Ever since, generations of economists and policymakers have vowed that never again would world trade implode and output shrink as happened in the 1930s.

So why the graphic reminder? Let's be clear. Global depression is not even on the horizon, much less an immediate prospect. But within the past few months, emerging Asian markets and their economies have tumbled like dominoes, the Russian economy has cratered, and now Latin countries are suffering capital flight. The once mighty Japanese economy remains comatose. In Washington and Moscow, leaders are under fire. Around the world, investors have gone on strike, dumping high-risk paper and, more recently, trimming their sails on Wall Street. Commodity prices are at 20-year lows. It has been several years since the global economy seemed quite so vulnerable. There's little room for error at times like these. A few missteps, and problems can turn into disasters.

FOUR POINTS. Here's what needs to happen. First, the Group of Seven nations should coordinate a cut in short-term interest rates in an explicit move to bolster the global economy. This won't mean much in Japan, where already-low rates are pushing on a string. It won't delight the Canadians, who are trying to prop up their currency, or please the Germans, loath to appear undisciplined. Several regional Federal Reserve chiefs still fret that inflation might rear its head in the U.S., while some folks think lower rates would merely be a sop to Wall Street. But all this is myopia, pure and simple. Growth is stalled in one-third of the global economy. The G-7 should demonstrate leadership and cut rates now.

Next, some working solutions must be found to alleviate the strains on global finance. This means Congress should provide the \$18 billion in funding owed to the International Monetary Fund, pronto. But it also means remaking the IMF. The organization stumbled badly over the past year in recommending painful austerity programs to its borrowers. It needs to change its tune. Instead of plumping for largely unachievable macroeconomic goals, a reconstituted IMF, stripped of its bureaucracy and populated by a few more green-eyed shade types, should be actively reviewing and assessing the balance sheets and risk factors of developing nations. Lending could then be directly linked to creditworthiness.

This would attack the global capital problem at its source, making it harder for emerging nations to issue short-term debt at will, which in turn would give the hot-money types fewer outlets. Interventionist solutions, dealing with the tidal waves of global capital, are not especially desirable. Capital controls are subject to abuse and circumvention, while foreign exchange controls, such as those Malaysia recently announced, amount to opting out of the global financial system.

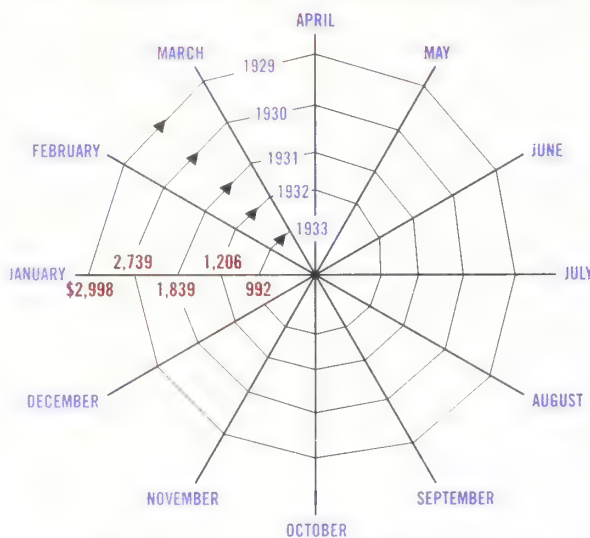
Third, the temptation to roll back the market-opening moves of the past two decades must be squarely resisted. Thanks to the slowdown in Asia, the U.S. trade deficit is already widening as America loses export markets. In Europe, preoccupation with monetary union could easily

spill over into a more inward-looking stance, one that's far less amenable to trade with Asia and Latin America. The U.S. still possesses an extraordinarily healthy and well-balanced economy, and it can easily play the lone locomotive of the global economy for a while if it must. But it cannot do so indefinitely, and as the trade deficit climbs, protectionist sentiment is sure to grow.

Finally, policymakers have to jettison their worries about inflation. The only inflation the U.S. has suffered is in stock prices, and that froth appears to be subsiding. So here's a recommendation that's simple but of overarching importance: Before they make a move, leaders around the globe should put every policy initiative to a growth test. Does the proposal promote economic growth, or is it restrictive? Will it have deflationary consequences? As history so amply illustrates, it is policy mistakes that turn slowdowns into depressions.

A CONTRACTING SPIRAL OF WORLD TRADE

JANUARY, 1929, TO MARCH, 1933:
TOTAL IMPORTS OF 75 COUNTRIES
MONTHLY VALUES IN TERMS OF OLD U.S. GOLD DOLLARS (MILLIONS)



DATA: LEAGUE OF NATIONS' MONTHLY BULLETIN OF STATISTICS, FEBRUARY 1934

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INSURANCE SERVICES PROVIDER GAB ROBINS INVESTS
TO FEED INFORMATION-HUNGRY CUSTOMERS

For insurers and corporate risk managers with claims to process, nothing matters more than information. It has to be quick, accurate, and intelligent. Janet Turoff, senior vice-president and CIO at GAB Robins, talks about how this insurance services provider invested \$40 million to create the most sophisticated reporting systems in the industry for its clients.

Q: How are the needs of your customers changing today?

A: There is a phenomenal rush toward more timely, integrated information. Customers don't want isolated reports. What corporate risk managers and insurers want is an integrated view of information which covers the first report of the injury or loss all the way through the adjustment of the claim to the MIS-generated analysis and reports.

Q: How has GAB Robins evolved to meet those needs?

A: Historically, our mainframe systems made it difficult to react quickly and flexibly to customer needs. Over the past few years GAB Robins has invested over \$40 million to completely overhaul our technology infrastructure. We made this substantial financial commitment because we realized that we are not just in the insurance services business, we are in the information business as well. That understanding is what differentiates us from our competition.

Q: How does that concept translate into customer services?

A: Today we can tailor our customer's unique information gathering requirements quickly and seamlessly through our client/server-based ACIS™ (Automated Claims Information System) core claims processing system. We can provide information-based reporting back to our customer in whatever format they prefer—paper, disk, tape, or through an online facility.

We have customers with tens of thousands of claims. They can access their claims information with us through our claims management products ClientTell™ (available today to our Risk Management customers) or the soon to be released ClaimConnect™ product (for our Insurance Company customers). Customers can download their claims information whenever it is convenient for them—real time or scheduled during off hours. Customers can use the built-in reporting

facilities of these tools or their own reporting tools.

We also have customer based advisory councils and focus groups who provide constant feedback loop on our tools and services so that we know we are focused on building our information-based tools to meet their needs.

Q: Impressive! What kind of technology do you have in place that enables you to provide information so flexibly?

A: We have two very strong vendor relationships—with Hewlett Packard and Oracle. We partnered with the technical lab staff and the Cupertino, California-based senior management teams of both HP and Oracle to help us build a scalable system that would

perform as we need it to. As a result, we were the first in the country with the implementation of the Oracle Parallel Server (OPS) technology in a high volume production environment. OPS is a new technology option that allows multiple computers to access the same databases with improved performance and reliability. That technology provided us

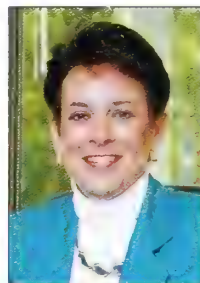
with the boost we needed to accommodate our growing online population.

Today we can handle 850 concurrent users on our systems and we can easily grow to 1,500 concurrent users with the same performance. This move to client/server also allowed us to maximize our infrastructure into the latest LAN, WAN, and desktop environments and provides us with the ability to quickly adapt to changing business needs and introduce new products.

Q: Were there other benefits from this substantial technology investment?

A: Absolutely! This platform will allow us to be completely Year 2000 compliant on our core claims processing systems.

Clara Van Hast, a New York-based writer reports frequently on insurance and risk management.



Janet Turoff, senior vice-president and CIO, GAB Robins North America, Inc.



At a catastrophe site, a GAB Robins claims adjuster uses an "untethered" laptop to enter claims information. The adjuster can enter data and generate reports with the remote computer, and upload the information later. This unique system should dramatically speed up claims processing for natural disasters, when telephone lines may not be readily available.

BusinessWeek

SEPTEMBER 21, 1998

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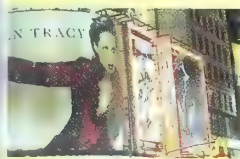
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MISFIRE

WALL STREET'S ROCKET SCIENTISTS thought they had a surefire way to beat the markets. Boy, were they wrong!



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COVER STORY

MISFIRE

August may go down as a landmark in high-tech money management: Investors lost billions, and "rocket scientists" lost their credibility page 114



BusinessWeek

SEPTEMBER 21, 1998



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Malaysia takes a big economic gamble page 46

Cover Story

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They're called "rocket scientists"—the high-tech strategists and Nobel laureates who use sophisticated computer models to search for market inefficiencies and surefire returns (or so they thought). They're deployed by nearly every major investment house in the U.S. and abroad. But then came bloody August—and massive losses

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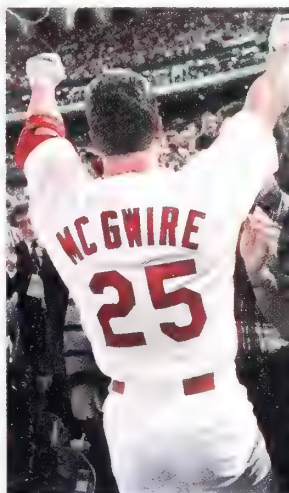


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Up Front

EDITED BY ROBERT McNATT

PAPER PLAYS

IT'S HARD TO KICK THAT RJR HABIT

CARL ICANH LIKED BEING AN RJR Nabisco shareholder so much he's back for another helping. The financier cleverly made a bundle last year by selling his entire 6% stake in RJR for about \$731 million as the stock price peaked in the high 30s. But lately, with the price in the low 20s, he has bought back about 3%, worth about \$230 million.

This time, both the food-and-tobacco giant and Wall Street believe Icahn will be a passive investor, though they caution he is unpredictable. In 1996, Icahn and financier Bennett LeBow tried to force RJR into spinning off its Nabisco division. They failed

and cashed out in 1997. But their timing was right: RJR stock surged on prospects of a national tobacco litigation settlement, which later fizzled. Icahn, who isn't talking, came away with around \$130 million in profits.

Now, analysts say, he's likely awaiting new attempts at a tobacco pact, which would ease RJR's lawsuit worries and encourage it to spin off Nabisco. As pure plays, the separate stock in Nabisco and tobacco would each rise, says Salomon Smith Barney analyst Martin Feldman. RJR Chairman Steven Goldstone



CARL ICANH

has said he would like to divest Nabisco, but only after a settlement. Moving sooner, he fears, risks antitobacco plaintiffs' objections that he is removing assets from their grasp. *Larry Light*

TALK SHOW "I was so shocked because I didn't think the ball had enough to get out."

—Mark McGwire, after No. 62

HONCHOS

TWO JUNK-BOND STARS FEEL TRASHED

CALL IT A FINANCIAL CULTURE clash: Two senior managers at Montgomery Securities are so irate at their new corporate parent, NationsBank, and its takeover of Montgomery's high yield business, that they may quit, **BUSINESS WEEK** has learned.

Tom Weisel, Montgomery's former chairman and CEO, and Jerry Markowitz, head of its high-yield operation, are "leaning" toward leaving the megabank, says a source at the company, despite contracts that would reward them handsomely for staying. While neither man has yet made a final

decision, both are said to be furious that the bank has taken the lucrative junk-bond business away from Montgomery's New York office and handed it to NationsBank managers in Charlotte, bank headquarters.

NationsBank spokeswoman Gina Mackin declined comment on "rumor and speculation."

The insider contends that the switch of operations violated last year's merger contract, which named Montgomery as high yield overseer. Mackin had no comment on the allegation.

Both Weisel and Markowitz are supposedly negotiating their exit packages in this latest clash between the culture of commercial and investment banking. *Joan Olea*



WEISEL

LITIGATION NATION

SMOKE AND MIRRORS FROM BIG TOBACCO?

ANTISMOKING ACTIVISTS ARE charging that the state tobacco settlements in Texas and Florida contain measures that may make life easier for Big Tobacco than first thought. Although Big Tobacco will pay billions for health-care costs and antismoking education, William Godshall, head of SmokeFree Pennsylvania, says the settlements contain

"tobacco industry protection provisions."

For instance, the settlements call for laws making tobacco possession by kids a criminal offense rather than simply cracking down on retailers who sell to minors. "That plays into the industry's strategy of positioning smoking as an adult habit," says Robin Hobart, co-director of Americans for Nonsmokers Rights. Activists fear that as "forbidden fruit" cigarettes will actually attract teens. In Florida, which already has criminalized underage tobacco possession, authorities say more than 2,700 kids have been nabbed, though they add there is no evidence such tactics reduce teen smoking. Minors can be fined \$25 or sentenced to 10 hours of community service. The industry says it also wants to crack down on retailers but defends efforts to criminalize possession. *John Carey*



WILD BLUE YONDER

NO EXCUSES NOT TO GO TO MINNEAPOLIS

MANY TRAVELERS THINK getting a plane ticket to Minneapolis as the Northwest Airlines strike drags on is nearly impossible. But there's an airline charging \$300 or less for round-trips between the Twin Cities and 16 major markets.

Sun Country Airlines is a 15-year-old charter carrier that started flying scheduled service two years ago and now stands to prosper from Northwest's woes. With \$200 million in revenues, the Mendota Heights (Minn.) airline is the second-largest carrier out of the Twin Cities after

Northwest, which controls 80% of that market. But Sun Country isn't in the computers of most corporate travel agents and doesn't advertise outside of Minnesota, so few know about it. Sun Country flies one or two nonstop flights daily to Chicago, Los Angeles, and New York, among other cities.

The carrier, already in the midst of expanding scheduled service, has stepped up the pace because of the strike. By March, Sun Country will fly about 100 scheduled flights a day, up 67% since earlier this summer. "The best thing that could happen to us is that people become aware of where we fly," says Lori Barghini, Sun Country's marketing director. *David Leonhardt*





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PRODUCT PEEK

MONITORS: I CAN SEE CLEARLY NOW

IF YOU'VE EVER LOOKED AT your computer's screen and had problems making out the small print or the fine details of charts and photographs, the problem likely isn't your eyes. The relatively coarse grain of computer displays just doesn't do a good job of rendering small type or subtle shadings.

Help is on the way. On Sept. 14, IBM will announce a flat-panel display screen with image quality equal to a good printed page. Code-named Roentgen, after the discoverer of X-rays, the 16.3-inch diagonal screen sports 200 pixels per inch, about four times the count of



PERFECT MATCH:
Original and on the screen

the best PC screens now. Pixels are the electronic components of images—more and smaller pixels mean a clearer image.

But don't expect your local CompUSA to carry this screen anytime soon. Although IBM is rushing to get Roentgen to market, there's not yet a display adapter for computers to produce images on-screen. Even when an adapter is ready, IBM sees radiologists as the prime market for Roentgen, not average consumers. The doctors will be able to better read X-rays over a PC with much higher quality, a particularly big help for images sent over long-distance networks. Expect Roentgen to cost in excess of \$10,000 when it's commercially available. *Stephen H. Wildstrom*



BIG TAB:
Dallas suites are \$2 million for 15 years

These boxes are no luxury for the teams. "The suites are one of the vital keys to

success for all teams," says George Hayes, marketing vice-president for the Dallas Cowboys. Bill Dorsey, of the Association of Luxury Suite Directors, calls suites "an explosive revenue area," expected to bring in \$250 million this year. That sum can only rise given the six new stadiums set to open by 2002.

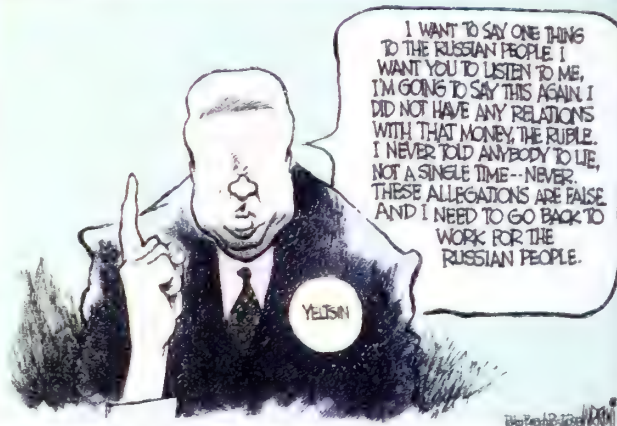
Corporations love to woo clients in luxury boxes. But feeding the dealmakers ain't cheap either: In Minneapolis' Metrodome, 18 hot dogs will set you back \$58, while a chip-and-dip tray costs \$39. But who cares, when a season's box there goes for only \$30,000? *Dennis Blank*

SPORTS BIZ

PIGSKIN PALACES IN THE SKY

READY FOR FOOTBALL? THEN you—or your company—better be ready to lay out big bucks to watch in style. In Dallas, where skyboxes are sold for 15-year terms, you can watch Troy Aikman for a mere \$2 million—then shower off the beer buzz in your marble bathroom. Prefer Florida in winter? Miami just hit a per-season record of \$250,000. Something a bit lower? The Buffalo Bills now lease dugout-level boxes for a bargain-basement \$40,610.

DRAWN & QUARTERED



FASHION FOLLIES

WHEN YOU WEAR WHAT YOU EAT

HAWAIIAN SHIRTMAKER CRAZY Shirts Inc. has come up with a solution for calorie-conscious chocoholics. It has introduced a line of T-shirts and sweats dyed in Ghirardelli chocolate. Wear one and you'll smell like you've indulged in a chocolate fest—without ruining your teeth.



And since few things go better with chocolate than a rich cup of java, Crazy Shirt, a privately owned company with about \$70 million in revenues, has also come up with a coffee-dyed T-shirt, redolent of

Hawaii's famous Kona coffee. The company says the chocolate smell lasts through several washings. The coffee fragrance may dissipate sooner. The shirts cost \$24 and up.

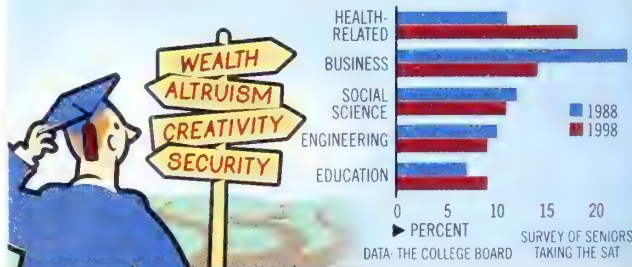
These aren't the first scented shirts. In the early '70s, other companies introduced scratch-and-sniff T-shirts, which proved a short-lived fad. But trends analyst B.L. Ochman thinks these Crazy Shirts could be the next Beanie Babies, although "they'll have to come up with more flavors." So Crazy Shirts is working on the next generation: shirts dyed in beer. Thankfully, they'll only have the color, says the company, not the smell. *Barbara Silverbush*

SWEET SMELLS:
Shirts of coffee and chocolate

THE BIG PICTURE

WHAT DO YOU WANT TO BE WHEN YOU GROW UP?

College-bound students peg health care as their top career choice, despite the dissatisfaction of many doctors and nurses with managed care. Meanwhile, going into business has lost its appeal over the past decade. The top five choices:





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Leopard Freed/Magnum

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when this community comes
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town is hit hard by tornadoes.

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NEW ECONOMY OR AN ECHO OF THE 1980s?

"The 21st century economy" (Cover Story, Aug. 24-31) reinforces the idea that America has entered the New Economy. Our era, however, seems eerily similar to the late 1980s—when the "Massachusetts Miracle" was announced. America in 1998 appears to be at a cyclical high point. Come a slowdown or recession, some Americans may be claiming "depression," as they did during the 1990-91 recession.

America does have strengths: low unemployment, steady growth, and overall wage growth. Nonetheless, the long-term trends of slow growth and high inequality remain. Both are no better than in the 1980s. In fact, inequality has increased more under Clinton than under Reagan.

Japan appears to be entering a financial situation similar to the U.S. in the 1930s, while the U.S. takes Britain's position (its '30s depression remained mild). Japan and Asia maintain fundamental strengths in production, while America's production strength diminishes (1988 saw record trade deficits with both Japan and China). Is this a historical coincidence or a harbinger of America's true future role in the New World Economy?

Drew Millet
Vestal, N.Y.

SCIENCE JOBS JUST DON'T PAY WELL ...

"Why the pace has to pick up" (Cover Story, Aug. 24-31) points out that not enough American students choose careers in scientific research, thereby necessitating the importation of foreign talent. It has been suggested that more money be given to research funding and to grants and fellowships to graduate students. This misses the point.

A prospective researcher must spend four years on an undergraduate degree, followed by four or five years of postgraduate education, followed by two or more years as a postdoctoral research

fellow just to have a chance at obtaining a position in academia or government research. If one is lucky enough to obtain an assistant professorship, then one has another six years to prove oneself worthy of tenure. But if unsuccessful, then one's career is essentially on the scrap heap.

There is, however, a more serious reason for avoiding science: It simply is not respected in North America. One can expect to live in poverty during one's graduate and postdoctoral years just when most people are starting a family. Your neighbors, be they plumbers or janitors, make more money than you do. Even if you do reach the ranks of full-time employment, typical salaries are a fraction of what medicine, law, or commerce pay. Sure, the work is fascinating, but try to explain that to your wife.

I now work in France. I earn the same as I did in North America—but that is more than most lawyers, accountants, and even doctors over here feel good about myself. I am in a privileged profession. Each year, my department hires four or five new scientists who will have lifetime jobs from the word go.

James Mitchell
Professor of Physics
Université de Rennes
Rennes, France

... AND OUTLAYS FOR RESEARCH ARE PALTRY, TOO

"The innovative society" (Editorial, Aug. 24-31) addresses the need for increased federal funding for research. Your statement that Washington needs "an economic policy with a top priority of encouraging innovation" was on target. Our coalition, which consists of the U.S. Chamber of Commerce from all parts of the U.S., believes that federal research funding should be increased. The most critical need is in defense basic research. Although it spurred the development of the transistor and the Internet, defense basic research is down by 30% in real dollars since its peak.

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l year 1993. Regaining this lost and needs to be a top priority in ral budget deliberations.

Jim Klocke
Executive Director
National Business Coalition
for Federal Research
Boston

S TIME, LET JAPAN VE ITS OWN PROBLEMS

agree with "New day, new rules" vs: Analysis & Commentary, Aug. 1) that the U.S. should not volunteer for a new yen rescue. Japan has repeatedly and miserably to correct its mistakes, share its responsibility in the world's second-largest economy, assume the leadership role it has been trying hard to gain on the world stage. On the other hand, the U.S. has helped Japan gain economic power since World War II and considered it an ally, especially in the cold war era. That era is gone now, and Japan has no idea what kind of ally it is in the economic crisis of the new era. It failed to help itself, let alone help the other countries in Asia.

Wei Xie
Lansdale, Pa.

ARMY WEATHER AHEAD OFFSHORE INVESTORS

Several months ago, I attended a seminar in Nassau, Bahamas, where one of the speakers was an employee of PaineWebber ("Offshore squall at PaineWebber," Finance, Aug. 17). The topic of the talk was that investors should use PaineWebber as a vehicle for offshore corporations (foreign companies owned by U.S. citizens "indirectly," the legal owner being the offshore agent). The talk ended with questions on how U.S. "indirect ownership" could bring investment profits back to the U.S. anonymously.

At no time was avoidance of U.S. taxes advocated: It just wasn't mentioned. I could tell, however, by talking to people at the seminar that most of them had concluded this was a terrific way to avoid U.S. income taxes. Because I was concerned that these investors were unknowingly committing themselves to actions that could lead to an Internal Revenue Service audit, I wrote a letter, marked "personal and confidential," to the president of PaineWebber, advising him that an employee was less than candid in his recent presentation. PaineWebber terminated the employee's services within two days and froze his customers' accounts. Four days after I sent my "confidential" letter, a BUSINESS WEEK

reporter called to ask me about the letter, of which she had a copy. I refused to comment on the contents of my letter, but she used it to write her article.

Now that the cat is out of the bag, I wouldn't be surprised to see the IRS follow through by investigating the tax reporting by these PaineWebber customers. My consolation is my belief that it was only a matter of time before this "investment scheme" came to the attention of the IRS. At least, the investors who read the article will be

forewarned and can file amended tax returns and pay their back taxes to avoid possible criminal prosecution.

Dan Ertel
Schenectady, N. Y.

HOME LOAN BANKS GET NO GOVERNMENT SUBSIDY

In "Uncle Sam is giving banks a free ride" (Finance, Aug. 17), you left out some facts and misinterpreted others. Congress established the Home Loan

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CORRECTIONS & CLARIFICATIONS

In "Why the pace has to pick up," one of the articles in "The 21st century economy" (Cover Story, Aug. 24-31), the chart was scaled incorrectly. The scale should have gone from 0% to 0.46%.

Banks to help provide adequate housing. The 12 regionally operated banks, with \$358 billion committed to nearly 7,000 community lenders, have done a tremendous job. But each family that needs better housing is another reason we still need the home loan bank system.

Community lenders borrow from the home loan banks because our wholesale products are competitively priced. Those savings are passed on to Americans in lower monthly housing costs. Our attractive prices result from a low-risk profile, high asset quality, conservative management, and high capital levels—in addition to our congressional charter.

The home loan bank system receives no taxpayer dollars and no government subsidy. But we provide more than \$100 million annually in direct grants to fund housing for the neediest of Americans. And we pay a flat tax of \$300 million each year into the Treasury to help finance the government's 1989 Resolution Trust Corp. bailout.

Your commentary is the tired echo of those on Wall Street and their Beltway apologists who are afraid of facing real competition on Main Street.

Alfred A. DelliBovi
President & Chief Executive
Federal Home Loan Bank
New York

THE RISKS OF TINKERING WITH CANADIAN HEALTH CARE

As a Canadian citizen and a resident of Britain, I must point out that Britain's mixed system is far worse than the one in Canada: In Britain, waiting times are measured in months, not weeks ("Canada's health-care system isn't a model anymore," News: Analysis & Commentary, Aug. 24-31).

Private health care competing with a publicly funded system is the thin edge of a wedge to separate the two completely—ultimately leading to the demise of universal coverage. The reason is simple: People using the private system would not want to pay for both systems when they are using only one. Being wealthier, they would be more capable of exerting political pressure to reduce their taxes, leaving the public

system to strangle from underfunding.

Contrary to what the Fraser Institute would have us believe, people rarely directly pay for medical care in any system. Most prefer to "socialize" their risk privately through insurance. As in the U.S. and elsewhere, insurance companies would have incentives to cherry-pick their clients. No doubt many would find themselves denied coverage, perhaps because of age or preexisting medical conditions. Children from families not able to afford coverage would be most at risk.

A single-payer system is still much more efficient, at least from an administrative and bargaining point of view, than any mishmash of private insurers can ever be, so total costs would be expected to rise. This isn't to say private elements can't, or shouldn't, be introduced to improve efficiency, but their impact on universality should first be put to the test. While the trend is toward private coverage, I question its motives and ultimate desirability.

Marc Charron
Troon, Scotland

THE CPI TAKES ALL CHARGES INTO ACCOUNT

In his letter "Prices may be stable, but add-on fees are soaring" (Readers Report, Aug. 17), Thomas J. Kerver implies that movements in the consumer price index (CPI) do not reflect service charges and other fees sometimes associated with consumer purchases. As a matter of fact, such fees are routinely taken into account in CPI calculations. As a rule, prices reflect the full amounts that consumers are actually charged.

Katharine G. Abraham
Commissioner
Labor Dept.
Washington

A DELUGE OF WARNINGS FROM THE WEATHER SERVICE

The National Weather Service supports public and private dissemination of information and applauds companies, such as those mentioned in "A blizzard of weather sites" (Personal Business, Aug. 3), for placing so much information on the Internet. But your readers should also know that while Dorothy may have avoided a trip to Oz by learning of an approaching twister through the World Wide Web, there is technology in place today that could have alerted her of pending tornadoes even if she were asleep or away from her PC!

The National Weather Service oper-

ates National Oceanic & Atmospheric Administration Weather Radio, which broadcasts severe weather warnings and forecasts nationwide to the public 24 hours a day. The newest NOAA Weather Radio receivers can be programmed down to the county level and are able to turn themselves on and alert even sleeping people of dangerous weather.

Yet advances in technology and improvements in warning times are useful if individuals are not prepared. The National Weather Service encourages people to plan ahead for hazards that affect their area and to move to a pre-designated place of safety when a tornado warning is issued by any media.

John J. Kelly
Director

National Weather Service
Commerce Dept.
Silver Spring, MD

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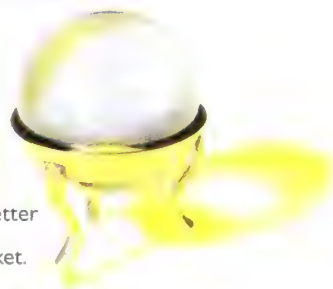
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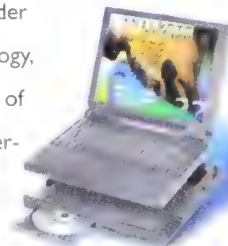
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EAST AND WEST

China, Power, and the Future of Asia

By Christopher Patten

Times Books • 304pp • \$25

THE BOOK MURDOCH TRIED TO QUASH

I arrived in Hong Kong one month after Chris Patten came to town in July, 1992. It was the beginning of an exciting time, as the colony's last British governor tried modestly to expand democracy despite intense opposition from China's Communist leaders. He angered the comrades so much that they referred to him as "the whore of the East."

Now, after reflecting on his five years in Asia, Patten draws some searing conclusions in *East and West: China, Power, and the Future of Asia*. This is the book that caused a flap in February, when publisher HarperCollins reneged on a contract to publish it in Britain. At first, the publishing house suggested that the manuscript was below standards. Later, it was forced to apologize when an internal memo surfaced, suggesting another motivation: corporate worries about friction with China, where HarperCollins' boss, Rupert Murdoch, has many business interests.

As expected, Patten takes aim at the Chinese. But they're not his only targets. He admonishes the British for holding back the development of a democratic political culture in Hong Kong. He urges the West to stop "coddling dictators" who are expert at playing off one batch of barbarians against another. And he condemns the mainland for its curtailment of civil liberties, accusing the Communist Party of "cynicism and decadence." "The Chinese government believes that all it has to do is to crack the whip—threaten a blocked order here, a purchase from a rival there...and we will all jump back into line. And by and large we actually do..."

But *East and West* is not a screed against critics who objected to Patten's unbending commitment to democratic principles and his willingness to stand up to Beijing. Nor is it a memoir. (Regrettably, he dedicates only three of the

book's 10 chapters to Hong Kong, and these lack the drama of the best inside accounts.) The book is mainly an attempt to assess such lofty concepts as whether there is a correlation between economic prosperity and political pluralism. Patten believes there is.

He dismisses the idea that so-called Asian values, with their emphasis on stability, hierarchy, and family, are responsible for regional growth. Progress in the East, he argues, has more to do with free trade and technology than with anything inherently Asian. The next millennium, he believes, belongs to open societies where innovation and creativity thrive.

Sound familiar? Such insights would have been more thought-provoking during Asia's boom, when authoritarian leaders got away with heavy-handed policies because they could also take credit for high growth rates. Now, more than a year into the financial crisis, any number of analysts have already made Patten's point that "Asian values" were just "a shorthand for the justification of authoritarianism, bossiness, and closed collusion rather than open accountability in economic management." And who seriously talks about any Asian economic "miracle" these days?

Patten's most provocative chapter is on China. He contends that the West should treat it like any other country and refuse to kowtow to a regime that is "at the end of an era." There is no correlation between bending to Beijing and benefiting economically, he says.

On the other hand, Patten believes that trade issues should be kept separate from human rights and other political hot potatoes. He says Washington's

yearly review of China's most favored nation trade status "distorts policy" and "plays into China's hands." Beijing doesn't believe the U.S. will yank MFN so it doesn't modify its behavior.

It is also not in Washington's interest, Patten argues, to impede the free flow of goods. He believes we should negotiate hard with China on trade issues, drop "our Marco Polo-like obsession with the Chinese market," and let business leaders determine whether China is worth the risk. He even suggests that "a moratorium on high-level trade visits" would be "a great bonus all around." At the same time, governments should pursue issues from weapons proliferation to human rights forcefully in international forums and directly with China.

It's really the West—and not China—that has the upper hand, as Patten sees it. "Without our money and our purchase of Chinese goods, the very future of the Communist regime would be imperiled," he says. "We spin the wheels for them."

That's worth saying. But as thoughtful as this book may be, it wasn't the one I wanted to read. There are plenty of pundits around to examine the Asian crisis. But Patten was uniquely placed to give personal insights on the struggle for Hong Kong's heart and soul in the last days of the British empire. For such an outspoken leader, he certainly shied away from

naming names of those who lobbied to curb freedoms that he believes are essential to Hong Kong's well-being.

Patten's hands-on leadership is missed by many people in Hong Kong, especially since his successor, a tycoon with no apparent political skills, seems to vanish whenever controversy arises. A consummate politician, Patten thrived on controversy and continues to generate it. Recently, a Hong Kong bookstore canceled a book-signing session, saying his analysis was too critical of China. (What on earth could the owners have expected from Patten?) I'm sure the last governor will have a few choice words to say about that.

BY JOYCE BARNATHAN

Barnathan is *BUSINESS WEEK's* Hong Kong bureau chief.



BENDING TO BEIJING WON'T PAY OFF IN ECONOMIC BENEFITS, PATTEN CONTENDS

STEPHEN H. WILDSTROM

GIVING THE OFFICE A TOUCH OF COLOR

new generation of ink-jet printers are ideal for small and midsized businesses

Not long ago, ink-jet printers were regarded as little more than toys. The inexpensive color printers were fine for home use and great for kids' school projects. But they were not taken seriously in the office. That's changing fast. Not only have people learned that color can add a lot of punch to a business document, but manufacturers are offering printers tailored to the office market. Epson and Hewlett-Packard are leading the way with ink-jet printers that can be plugged right into the Ethernet network common to offices. These machines are ideal for a small to medium-size business or a corporate work group.

BACK ART. The \$549 Epson Stylus 850N is a version of the popular Stylus 850 with an Ethernet connector added to the existing PC and Macintosh ports. This allows the printer to be hooked up to anything from a network run by a big corporate Novell Netware server or Windows NT LAN to a simple Windows network with no dedicated server.

Epson didn't stop at making the printer network-ready; they went a long way toward making networking simple. Microsoft has always treated the process of adding a printer to a Windows network as a back art. The instructions

have been hidden in obscure manuals and, once found, were comprehensible only to network administrators. Epson has demystified the process. The manual and software with the 850N provide step-by-step instructions that make installing it almost as simple as putting a printer on a Mac network.

The \$1,199 HP DeskJet 2000CN, as its price would indicate, is aimed at a somewhat higher market segment. The Epson can hold 100 sheets of blank paper, while the HP holds 400. The HP's two paper trays allow loading two different types of paper, such as plain stock and letterhead stationery. The HP is also bigger, heavier, and more solid.

HP has tried to simplify the job of network installation,

but while the instructions are reasonably easy to follow, they're not as simple as Epson's. Part of the problem is the software provided for managing printers over a network. HP supplies a copy of its JetAdmin package. This is an excellent tool for managing dozens of printers of different types on a large network, but it's a bit overwhelming. Epson's software

per black-only page. HP color is cheaper: 5.2¢ per page vs. Epson's 8.8¢.

Although the HP claims to be significantly faster, I found very little difference. Printing 10 copies of a one-page black-only memo took 1 minute, 54 seconds on the Epson and 2:10 on the HP, measured from the time I clicked the "print" button in Microsoft Word until the last page emerged from the printer. A nine-page document mixing text and color graphics took 4 minutes on the HP and 4:07 on the Epson.

The quality comparison was a mixed bag. With plain paper at each printer's standard quality setting, the Epson produced slightly crisper text. Both were acceptable, though neither was as good as a monochrome HP LaserJet 3100. The HP gave sharper and much less grainy graphics.

SOLID CHOICE. Neither of these printers is designed to produce, say, 100 copies of a memo or a flyer for distribution. Jobs like that are better suited for color laser printers, which start at about \$3,000. Of course, you can always print out a single copy of a color document and then have it duplicated by a corporate graphics department or an outside copy service. But either is a solid choice to be shared by perhaps a dozen users (or as a secondary printer for a larger group of workers who occasionally need color). The more rugged HP is designed for heavier-duty use, since it holds far more paper and requires fewer ink changes. But if you have Macs on your network, Epson is the only choice, since the HP supports only Windows.

In price, as well as capability, these units fit neatly between personal printers and big corporate workhorses. They are likely to find a place in many offices.



HEWLETT-PACKARD DESKJET 2000CN

\$1,199 SYSTEMS SUPPORTED:

Windows 3.1, 95, 98, NT 4.0

is only intended to handle an Epson ink-jet or two, but it's much simpler to use.

Most consumer ink-jet printers use ink cartridges that are much more expensive than they need to be because you have to replace the complete print head, including electronics, every time you run out of ink. Epson long ago separated the ink supply from the longer-lived print head. Now, HP has gone a step further, using four ink tanks instead of two, so you don't have to throw away cyan and yellow ink because you've run out of magenta. HP estimates a set of the cartridges will provide 1,700 color pages and 1,400 black-only pages. Epson's black cartridge is rated for 900 pages, and the three-color tank is good for 300 pages. Your mileage will vary, obviously, but both companies estimate the cost of supplies at 3.2¢



EPSON STYLUS 850N

\$549 SYSTEMS SUPPORTED: Windows 3.1, 95, 98, NT 4.0; Macintosh

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TO MANAGE MY DATA NETWORK
WITHOUT HIRING AN ARMY?!

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BY LAURA D'ANDREA TYSON

A FEW HOME TRUTHS AMID THE GLOBAL TUMULT



ANXIETY:
The "irrational
exuberance"
in the markets
a couple of
years ago
gave way to a
rush for the
exits that was
equally
irrational

Laura D'Andrea Tyson is dean of the Haas School of Business at the University of California at Berkeley and was President Clinton's chief economic adviser.

What's an economic pundit to do when faced with the challenge of writing an opinion column for business readers in a period of such great uncertainty in global financial markets? There are so many momentous questions to explore. Will Japan pass a credible bank reform? Who will lead Russia from the brink of bankruptcy? Will China devalue? Will the hordes of new investors in the U.S. stock market lose their cool and flee to safer portfolios? Will the Federal Reserve lower interest rates?

Frankly, I can't answer any of these questions with certainty, and unlike many pundits, I'm not foolish enough to pretend I can. So I've decided to reflect on the economic truths that have been confirmed by recent developments.

First, greed is not enough. Without a strong rule of law, transparent financial institutions, and legitimate corporate and political governance, greed spawns not the marvels of the market but the mischief of crony capitalism. A working tax system may distort market incentives. But Oliver Wendell Holmes was right—taxes are the price for a civilized and orderly society. Strong central banks may create large bureaucracies and regulatory headaches. But without them, economies can be brought to their knees by the excesses of misguided, sometimes corrupt, investors. With rules in place, privatization can promote innovation; without them, it can amount to little more than sophisticated robbery.

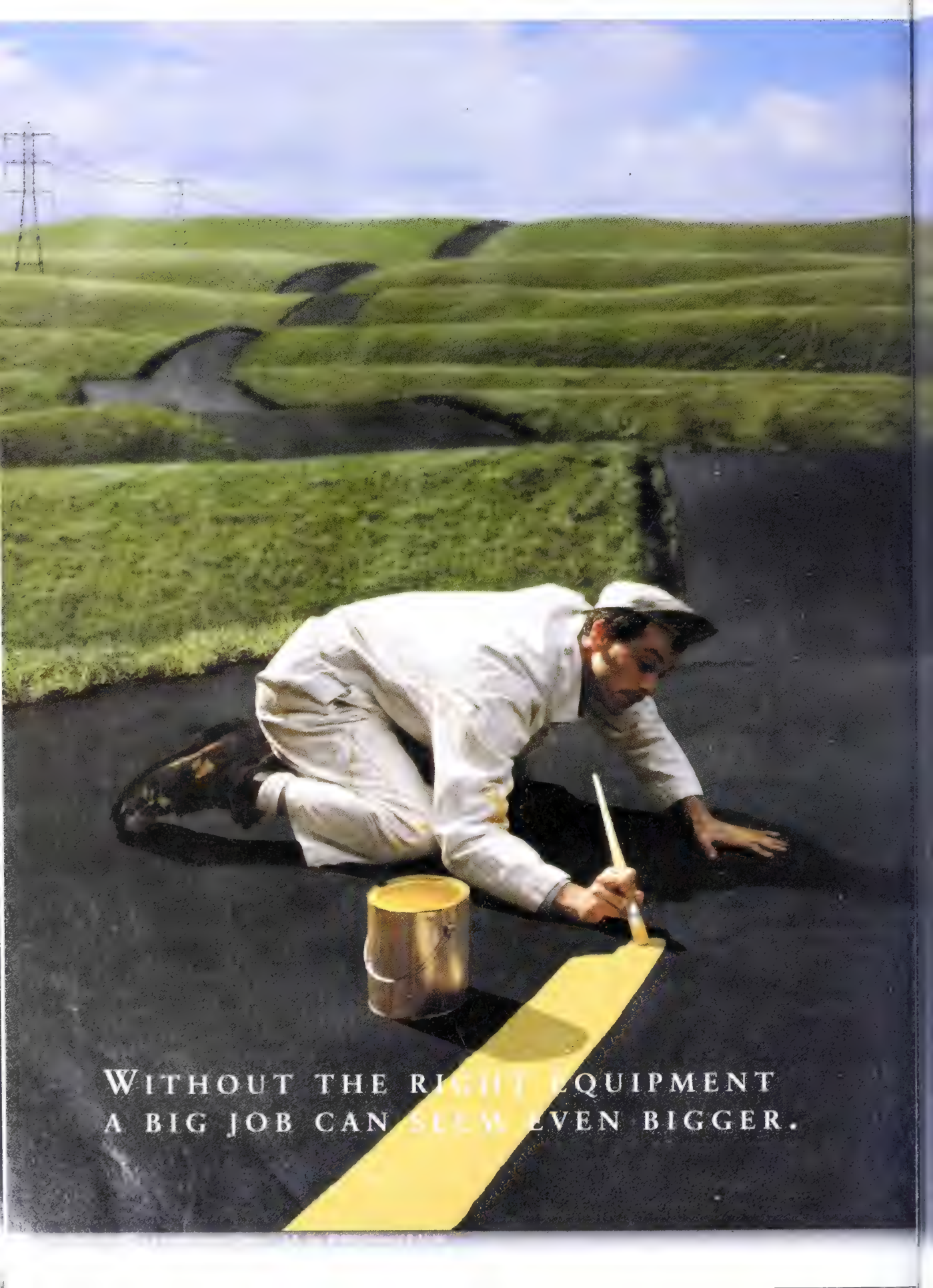
DISRUPTIVE CHANGE. Second, growing economic interdependence among nations has both benefits and drawbacks. Although freer cross-border flows of capital facilitate the efficient allocation of investment around the world, they can also produce disruptive changes in exchange rates and asset prices, setting off a vicious cycle of financial collapse, deflation, and contagion. Unfortunately, what Alan Greenspan refers to as the "patchwork of arrangements and conventions to govern the international financial system" has not kept pace with its breakneck dynamics. The world needs new multilateral governance arrangements, and whatever its shortcomings in Asia and Russia, the International Monetary Fund must play a key role.

Third, massive short-term borrowing in foreign currency is especially risky business. Countries with the deepest crises over the past year attracted vast amounts of short-

term foreign capital by offering the promise of high returns and fixed exchange rates. When the promise proved hollow, foreign lending contracted suddenly and violently, and even creditworthy projects found themselves starved for liquidity. By contrast, China's insulation from short-term capital also insulated it from overnight changes in credit availability. Even some straitlaced economists have begun to question the case for the free movement of short-term capital into emerging market economies. Is Prime Minister Mahathir Mohamad of Malaysia right?

THE UNTHINKABLE. Fourth, the U.S., along with the other members of the Group of Seven, should have put together a new Marshall Plan to ease the transition of the former Soviet empire into the global economy. It was willing to finance a huge cold-war military budget but not spend even a fraction of that amount to promote Russian reform. Now Russia has done the unthinkable. It has unilaterally declared a debt rescheduling that has badly burned foreign private creditors, making it even less likely that private capital flows will be sufficient to transform Russia into a stable market democracy. The recent riots in Indonesia were unnerving; the possibility of similar riots in Russia with its nuclear weapons is positively chilling.

Fifth, at critical moments in the world economy, whether it's the old economy of the 1930s or the new economy of the 1990s, human emotions can overwhelm market fundamentals. Euphoria about the Asian economic model, about development in Russia, about the potential of Internet and information technologies, and about the end of the business cycle in a world of flexible production techniques led investors to discount risk and to price equity markets for perfection. Then, as they began to realize that their expectations were unrealistic, panic blurred their ability to perceive meaningful differences in the economic fundamentals of individual countries and companies. "Irrational exuberance" gave way to an irrational rush for the door, and confidence, which is essential to the smooth functioning of markets, was shattered. Which just goes to show that no matter how sophisticated the world's technologies become they may never be able to control the recurrent bouts of euphoria and panic that are part of the human psyche and an essential ingredient of the business cycle.



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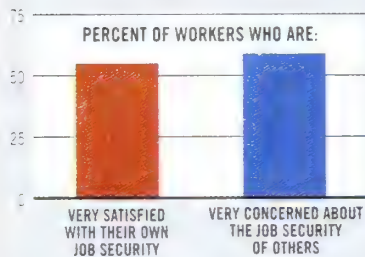
BY GENE KORETZ

WHICH WAY ARE WAGES HEADED?

A key: Worker views of job security

By most counts, the employment picture in the U.S. couldn't be much better. The jobless rate is hanging in at close to a 30-year low. Although manufacturers affected by Asian woes are no longer expanding, overall job growth remains healthy. And both the average

AMERICANS STILL FRET ABOUT JOB SECURITY



DATA: HELDRICH CENTER FOR WORKFORCE DEVELOPMENT, RUTGERS U. CENTER FOR SURVEY RESEARCH & ANALYSIS, U. OF CONNECTICUT

duration of unemployment and the number of workers who have been working part-time involuntarily hit cyclical lows in August. Yet, even as their own situations improve, Americans still believe that job security is a major problem confronting workers.

According to a new quarterly nationwide survey of U.S. workers inaugurated in August by Rutgers University's Heldrich Center for Workforce Development and the University of Connecticut's Center for Survey Research & Analysis, some 59% of the respondents say they are very concerned about job security for "those currently at work"—that is, for workers in general. An additional 28% indicate they are "somewhat concerned." (Interestingly, only 31% say they are very concerned about the performance of the stock market.)

That doesn't mean that people are fearful of being laid off. When asked about their own jobs, 55% of workers report that they are very satisfied with their job security; 31% say they are somewhat satisfied. But a fifth doubt that working hard would guarantee them a job until retirement, and less than half expect to be working for the same employer in five years. "People may be feeling more secure in today's strong labor market," says Carl E. Van

Horn of Rutgers University, "but the perception of declining job security in the economy is still very much alive."

The issue, of course, is more than academic. With wages rising more rapidly over the past year and the jobless rate so low, fears of a sharp inflationary acceleration in labor costs are rampant in financial circles. Many observers, including Federal Reserve Board Chairman Alan Greenspan, have attributed slow wage growth in the current expansion to "greater worker insecurity." If workers become more secure and less docile, so the reasoning goes, inflationary pressures will escalate.

Whether this is happening yet is open to question. Survey results aside, a key measure of worker security—the quit rate, or voluntary job leavers as a percent of those unemployed—continues to languish below the levels reached in earlier expansions, suggesting that workers still lack confidence about job prospects. The acceleration in wage growth over the past year appears to be more the result of employers bidding for scarce workers than of employees putting pressure on their bosses.

If the economy slows in the months ahead, as many forecasters are predicting, wage pressures should abate. And worries about job security will probably grow. Indeed, one ominous trend from the standpoint of workers is a sharp pickup in layoffs by U.S. companies. According to Challenger, Gray & Christmas Inc., which tracks such announcements, planned job cuts through August are up 37% from last year.

TO HAVE, TO HOLD, TO PROSPER

Why most married men earn more

It's well known that married men on average earn 10% to 20% more than their male peers (those with similar ages, educational backgrounds, etc.) who have never tied the knot. Less clear is the reason for this "marriage premium."

Many people believe that it's the institution of marriage itself that makes the difference—by inspiring men to settle down and by allowing them more time to devote to their careers rather than to household tasks. Others argue that married men earn more because women tend to select good providers and because men who choose to marry tend to be good workers.

In a recent study, economists Donna Ginther of Washington University in St.

Louis and Madeline Zavodny of the Federal Reserve Bank of Atlanta throw light on this issue by comparing the wage profiles of a group of married men in "shotgun weddings"—men whose marriages were followed by a birth within seven months—with the wage histories of similar men whose marriages weren't followed by such births.

If marriage itself causes the wage premium, they write, then both groups of men should do equally well. If the premium reflects a selection process prior to marriage, on the other hand, men forced into shotgun weddings should fare worse. (The study uses data from the 1970s, when out-of-wedlock births were less common.)

Their finding: Men involved in shotgun weddings don't show the wage advantage that other married men do. In short, the marriage premium appears mainly to reflect a selection process.

THE REWARDS OF QUALITY AWARDS

They presage bottom-line gains

Receiving a quality award is more than a feather in the cap of corporate management. According to a study by Vinod Singhal of the Georgia Institute of Technology and Kevin Hendricks of the College of William & Mary, such awards herald long-lasting improvements in companies' bottom-line results.

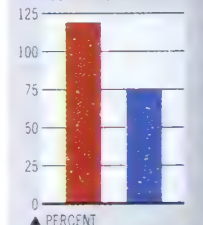
The study assessed the performances of some 600 publicly traded winners of 140 annual awards doled out by state and private agencies, as well as by major corporations to suppliers. Comparing their track records over five-year periods (from a year prior to an award to four years later) with a control sample of matched companies, it found that the award winners did about 50% better in stock appreciation, and two to three times as well in growth of operating income, sales, assets, and employment.

The results, says Singhal, "indicate that effective adoption of quality principles makes good economic sense."

HOW WINNERS WIN ON WALL STREET

STOCK PRICE CHANGE OVER FIVE YEARS*

■ QUALITY AWARD WINNERS
■ CONTROL GROUP



*FROM ONE YEAR BEFORE RECEIVING AWARD TO FOUR YEARS AFTER 1990 AWARD WINNERS FROM 1983 TO 1993

DATA: VINOD SINGHAL AND KEVIN HENDRICKS



Horizons

ow a great diversity of location and emphasis. All of them do, however, have something in common: how they got started. And that is by serving a locally-based, high-powered life sciences sector. These sectors' size and output, in turn, derive directly from innovativeness of their areas' research communities.

Germany's state of Hessen, one of the world's great biotech centers, mirrors this three-part age. The state is home to what arguably the country's largest biotech cluster, the Rhine-Main region, which is centered in Frankfurt and which extends throughout southwestern Hessen and eastern Rheinland-Pfalz. There are over 100 biotech companies in Rhine-Main.

One such company is B.R.A.I.N. (Biotechnology Research and Information Network) in Zwingenberg. Dr. Martin Langer, director of molecular biology of B.R.A.I.N., answers questions about his company's development in Hessen.

Please outline the development of your biotech operations, both general and specific, in Hessen and in Germany.

Our company was founded in 1993. It served as a consultant and had two employees. In 1994, we began conducting research in rented laboratories. In 1996, we moved into proprietary facilities. Today, we have 28 employees and provide our customers, generally small and medium-sized companies and the large multinationals, with full-service research outsourcing services. Our ability to do so is predicated on our having all official permits and our stock of in-house equipment and infrastructure.

What factors induced your company to set up shop in Hessen? Please describe the site selection process.

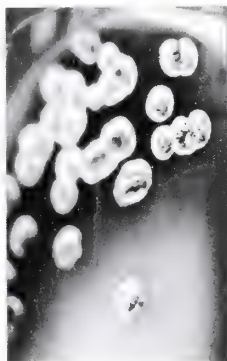
"We conducted the site selection process in 1995. We surveyed communities in several states including Hessen. Our reasons for setting up shop in

"We work closely with the state's universities and dedicated research institutes."

Synergies in research

Over the past decade, biotech has been added to the range of expertise of universities and polytechnics. Much of their biotech research and develop-

(Mittelständische Beteiligungsgesellschaft Hessen), a company funded by the public sector and by members of the state's powerful financial sector or from the state's life sciences producers themselves. Frankfurt's MainGen Biotechnologie GmbH is a very good example. Recently founded by Frank-



Biotech in Hessen:

"Here we have a large customer, subcontractor and supplier base."

Dr. Martin Langer, director of molecular biology, B.R.A.I.N.

Hessen was the commitment to promoting biotech displayed by the state's Ministry of Economic Affairs. This commitment has taken the form of assistance services and support. Also important to us was the state's central location. Frankfurt, Darmstadt, Heidelberg and other major centers of pharmaceutical and chemical activity are within immediate reach of Zwingenberg, a community located in the state's southern reaches. The Rhine-Main and Rhine-Neckar regions are two of Europe's most important business hubs. For us, this centrality means that we have immediate access to a large number of customers, subcontractors and suppliers."

In which ways do your researchers and developers avail themselves of Hessen's biotech resources such as local scientists and companies?

ment is now being carried out at institutes on or near their campuses.

These new facilities include the University of Giessen's Institute for Biochemistry and its Center for Interdisciplinary Research into Bioscientific Methods of Protecting the Environment, and the University of Frankfurt's Center for Biosciences. Also recently set up have been a range of biotech-related technology transfer centers, including Marburg's Center for Applied Bioelectrochemical Sensorics and Giessen's Mid-Hessen Biotechnology Institute.

Substantial state support

These projects also have something in common: how they got started up. And that was with the help of generous support from the government of Hessen. This support often comes in the form of equity or venture capital from the MFG

furt's Asta Medica and by scientists working for the University of Frankfurt, the new company will market biogenetic-based methods of treating cancer.

Hessen, centrally positioned in Europe, is one of Germany's most dynamic federal states with a thriving diversified economy which includes the country's financial capital Frankfurt. In fact, Hessen is among Germany's leading federal states in attracting foreign direct investment.

"Horizons" is published by HLT, the Economic Development Agency of the German federal state of Hessen, to provide U.S. companies and their managers with regular information about the economic, corporate and political environment in Germany. To find out more about investment opportunities in Hessen, please contact:

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a limit on
what can be
accomplished."**

— Christopher Reeve
Vice Chairman of N.O.D.



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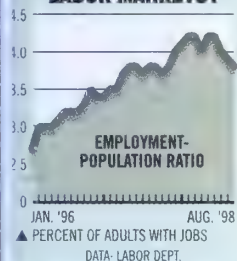
BY JAMES C. COOPER & KATHLEEN MADIGAN

A KEY PROP UNDER DEMAND IS IN DANGER

Will the stock market correction lead to slower job growth?

U.S. ECONOMY The U.S. stock market's volatility in recent weeks has focused attention on the outlook for economic growth—and rightfully so. Up to now, exceptionally supportive financial conditions, including both rising stock prices and falling long-term interest rates, along with the strongest job market in a generation, have been the power behind domestic demand. Spending by consumers and businesses has swamped the sizable drag coming from the financial meltdown outside the U.S. But now, market weakness threatens that crucial underpinning. And if U.S. demand cools off, the labor markets are sure to feel the chill.

A PRELUDE TO LOOSER LABOR MARKETS?



Federal Reserve Chairman Alan Greenspan mentioned these concerns on Sept. 4 at the University of California at Berkeley. Greenspan's speech was devoted almost exclusively to the question: "Is there a new economy?" The gist of his answer: "Let's wait and see." But he did digress briefly to say that greatly increasing stress in the world was unlikely to leave the U.S. unscathed. "As dislocations grow in amount, feeding back on our financial markets, restraint is likely to intensify," he said.

In this context, Greenspan made only one policy-related statement, saying that by the time of the Aug. 18 policy meeting, the risks between higher inflation and a weaker economy "had become balanced." That comment strongly suggests that the Fed rescinded its interest-rate policy bias toward higher interest rates that had been in place since May, and that it had adopted a neutral stance. He also said that the Fed "will need to consider carefully the potential ramifications of ongoing developments since that meeting."

THE PRESS AND THE STOCK MARKET interpreted that remark as leaving the door open for a cut in interest rates. The Dow Jones industrial average surged 30 points on Sept. 8. Greenspan did not, however, signal that a rate cut was imminent. For that interpretation to be true, the Fed chief would have to have placed a greater risk on a weakening economy than on higher inflation, a statement that would have implied that the Fed had shifted its inter-meeting stance all the

way to a bias toward easing. He didn't go that far.

For now, the Fed seems content to continue sitting on the sidelines, especially since the Wall Street correction is essentially doing the Fed's job of keeping growth at a sustainable, noninflationary rate.

That wasn't the case a few months ago. Greenspan also noted in his speech that the stock market's windfall gains had "financed not only higher personal-consumption expenditures but home purchases as well." In fact, he said that it was difficult to explain the recent record level of home sales without reference to earlier stock market gains, and he added that the rise in stock prices also had cut the equity cost of capital, fueling additional capital investment.

Strong domestic demand was why Greenspan and others at the Fed had been so concerned about the inflation potential of tight labor markets. Now, though, continued strength in job growth cannot be taken for granted. The employment-population ratio has edged lower in recent months, suggesting that the economy is less able to absorb incoming

workers. And the weakness in manufacturing payrolls has intensified as a result of weaker exports (charts). Absent the market component of spending growth, overall demand, including the service sector, seems likely to slow a notch—and so will payrolls.

IN FACT, JOB GROWTH may have begun to slow in the third quarter. August work rosters increased by 365,000 employees, after rising only 68,000 in July. The General Motors Corp. strike distorted the monthly pattern: Some 150,000 workers in auto and auto-related industries were off the job in July and then returned to work by August. On balance, payroll gains in July and August averaged 217,000 per month, but that was below the 244,000 averaged in the first half. Moreover, all of the August hiring decisions were made before the stock market began to tank.

The hiring slowdown can be traced to one of this year's economic trends: deteriorating manufacturing activity offset by a strong service sector. Factory payrolls rebounded by 95,000 in August, after dropping by 200,000 in July. That pattern, however, masks a wors-

THE TWO SIDES OF THE TREND IN PAYROLLS



ening trend. Factory-job losses averaged 23,000 per month in May and June, but looking through the strike impact, factories have shed more than 50,000 workers per month since June.

So far, though, service employment shows no signs of slowing down. Excluding government, gains in private-sector service jobs averaged 220,000 per month in July and August, actually faster than the 203,000-a-month average for the first half.

The question is: How long can service-job growth remain strong amid the erosion in manufacturing, on which many service-sector jobs, especially in wholesale and retail trade, depend? Moreover, finance has been a key source of job growth, but Wall Street's expected trading losses could hit hiring. That's why all eyes will be on the September and October job data, as well as weekly initial jobless claims, looking for early evidence that job markets are loosening up.

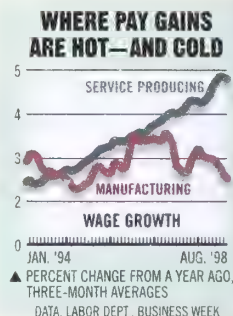
SEVERAL FED POLICYMAKERS are undoubtedly hoping that some easing in labor-market conditions will stem the acceleration in wages—and any resulting inflation pressures that they bring. But for now, wage gains show no sign of abating. Hourly pay jumped 0.5% in August, after increasing 0.2% in July, although some of that pickup reflected the return of highly paid auto workers. Still, during the past three months, pay has risen 4.2% from the same period a year ago,

up from a 3.7% annual clip this time last year.

Just as in job trends, the service sector is powering pay gains (chart). Measured over three-month periods, service wages are growing at a 4.8% clip from a year ago. Meanwhile, factory wage growth has slowed to 2.5%, after hitting 3.5% in early 1997. Factory pay growth is now the slowest in three years.

It's not, however, the inflation consequences of accelerating pay raises that bear watching right now. With global turmoil limiting the pricing power of U.S. companies, faster wage growth is more likely to shrink profits. Weaker earnings could hammer stock prices further and depress capital spending, both of which could ultimately lead to layoffs or weaker job growth.

So far, global turmoil is playing into Greenspan's hands. His top concerns for months have been strong demand, an overvalued stock market, and tight labor markets. But now, the stock market looks less frothy, and chances are better that overall demand will slow. To be sure, the Fed stands ready to act should the economy need help. But up to now, the script is unfolding just the way Greenspan would probably like.



FRANCE

LETTING UP ON THE ACCELERATOR

France's Socialist-led government has benefited from the growing economy it inherited last year. It easily met the Maastricht budget-deficit target, joblessness has been falling, and 1998 growth is headed toward 3%, the fastest pace since 1989. Now comes the hard part. The economy is set to slow, perhaps considerably.

The slowdown will make it difficult for the government to deliver on its promises of 350,000 new jobs by 2000 and more outlays for education and health while meeting its 1999 budget-deficit target of 2.3% of gross domestic product, as outlined in the budget blueprint released on Sept. 9. A key proposal includes the elimina-

tion of the *taxe professionnelle*, which has limited the hiring of unskilled workers.

The budget projects 3.1% GDP growth in 1998, slowing to 2.7% in 1999, but private analysts say that figure should be closer to 2.5%. They say the government is underestimating the degree to which economic turmoil in Asia and Russia will offset domestic demand.

Second-quarter real GDP rose 0.7%, slightly faster than the first quarter's 0.6% gain.

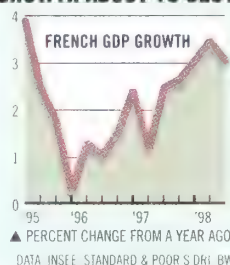
Further growth, however, will depend critically on domestic demand. Consumer spending, which had been stagnant for three years, led overall growth last quarter, rising a solid 1%. Also,

housing is accelerating, buoyed by rising real incomes and low interest rates. Unemployment is down, and confidence is high.

On the other hand, French joblessness, at 11.8%, is exceeded in the 11-country euro area only by Spain and Finland. And with manufacturing output now slowing, grudging declines in the jobless rate are likely to taper off. Factories had put on many temporary and part-time workers, and the temporary jobs added because of the World Cup are now gone.

Exports, which had led the economy for two years, have ground to a halt. They barely rose last quarter and were a net negative in the first half. Few economists believe that strong trade within the euro zone can offset the drag from the rest of the world.

IS FRENCH ECONOMIC GROWTH ABOUT TO SLOW?



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BREAKING THE PLASTIC MOLD.™

We're about to learn just how crucial information technology really is to U.S. prosperity. With economic malaise spreading from Asia, Russia, and Latin America, and plunging markets dimming the prospects for the financial-services business, high tech is increasingly critical to the U.S. economy. In coming months, the performance of high-tech companies—everything from chipmakers to operators of Web search engines—could become a barometer for the economy, not just a signal of what's hot in the stock market. So from Silicon Valley to Boston, high-tech execs are anxiously trying to determine how quickly businesses and consumers will continue to snap up computers, wireless phones, networks, and all the other high-tech gear.

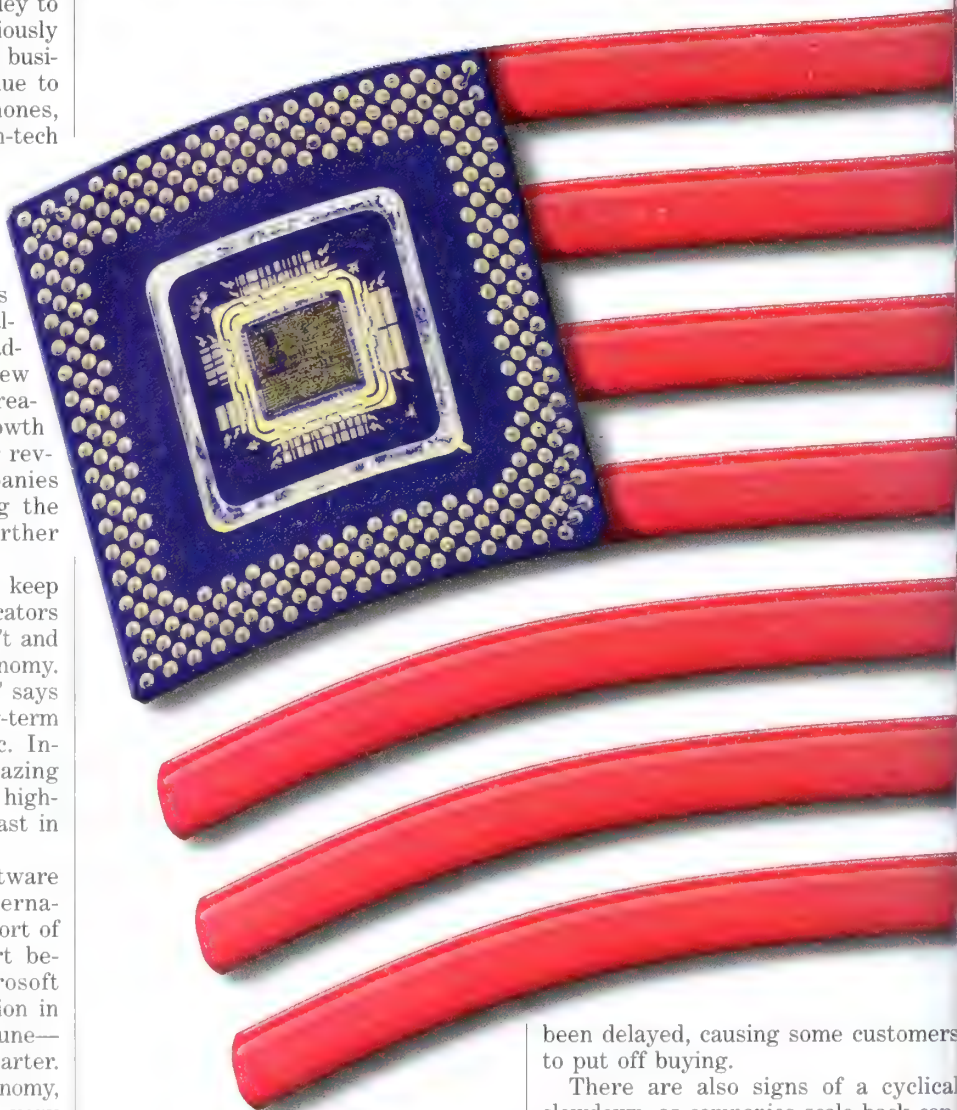
A falloff in technology spending would hurt the economy in several ways. Lately, high-tech spending has generated roughly 30% of the growth in U.S. gross domestic product, according to calculations by *BUSINESS WEEK*. In addition, business investments in new technology are one of the major reasons for strong productivity growth and low inflation. And with lower revenue and earnings, tech companies might fall behind in developing the next breakthroughs to spur further productivity gains.

"VERY DEPRESSING." Can high tech keep chugging away? Some prognosticators are already predicting that it can't and warn of a hit to the overall economy. "It's going to slow U.S. growth," says Genio Staranczak, director of long-term forecasting for WEFA Group Inc. Indeed, after six years of amazing growth, several segments of the high-tech industry are slowing—at least in the near term.

Some companies, such as software giant Computer Associates International Inc. and IBM, are falling short of revenue and profit goals in part because of the Asian crisis. Microsoft Corp. had revenues of \$400 million in Japan for the quarter ended in June—down 27% from the previous quarter. "What we see in the Japanese economy, at least in our segment, is very, very depressing," says Greg Maffei, Microsoft's chief financial officer. "It's a huge drag on our business."

Back in the U.S., PC makers are feeling the pinch from plunging prices in the consumer business. You can buy a new PC for as little as \$399 today, and that may not be the bottom. So even though unit demand is strong,

TECH TO THE RESCUE?



earnings are weak: After falling by 20% in the first quarter, gross margins for PC makers edged back up by only 8% in the second quarter, according to Deloitte & Touche. And in the more profitable corporate market, the outlook has dimmed. Microsoft's NT 5.0 operating system and Intel Corp.'s powerful Merced computer chip have both

been delayed, causing some customers to put off buying.

There are also signs of a cyclical slowdown, as companies scale back capital spending in anticipation of slower growth in the U.S. That hits makers of high-tech gear hard. Says Vlad Catto, chief economist for Texas Instruments Inc.: "We've seen a very sharp reduction in capital spending all over the place." Orders for new information technology equipment in the U.S. grew by only 8.2% for the three months that

tech spending has been
eroding the economy and
it continue to do so—if the
strategy can solve its short-
term problems

ended in July, down from an average of 11% for the past two years, according to U.S. Census Bureau data. Communications equipment and electronic components—categories that include the building blocks for big infrastructure projects—are especially hard hit.

One big stimulus for high-tech sales may now have peaked: Between 1994 and this year, spending on new gear and services to head off the Year 2000 problem jumped from 2.1% of corporate revenues to 4.1% in 1998, according to the Gartner Group Inc. That was a huge windfall for technology companies, but the biggest Y2K spending may be past.

The bottom line: The market for information technology in the U.S., totaling \$316.6 billion in 1997, will grow at 10.5% this year, compared with 12% in 1997, according to International Data Corp. Because the U.S. market is maturing, IT spending "won't grow at the high rates of the '80s and early '90s," says Matthew M. Toolan, manager of global research for IDC.

That's hardly a disaster. But slower growth and falling prices can only spell more bottom-line trouble: Computer makers, according to analysts polled by First Call Corp., are expected to post a profit drop of 2% this year, while the net income of communications technology makers is forecast to fall 10%.

That, however, is nothing compared with the woes of chipmakers, who compete in a glutted global market.

Many analysts predict an uptick in 1999, but First Call's consensus estimates predict a 35% plunge in profits of U.S. chipmakers in 1998.

Industry giant Intel is a clear victim. The company has recently rejiggered its

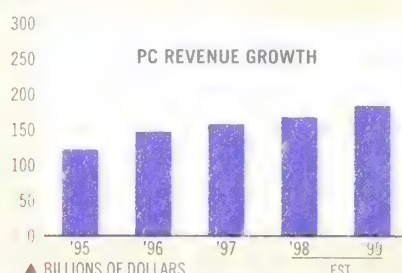
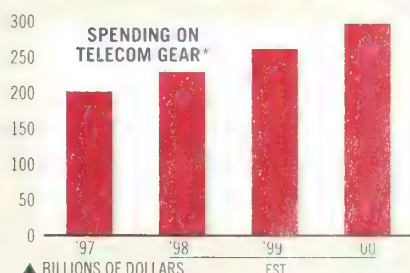
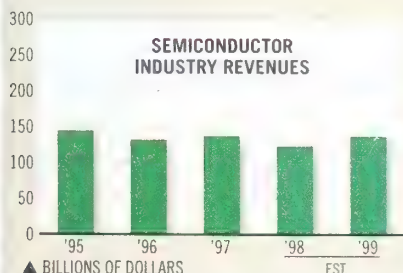
strategy to win back the sub-\$1,000 PC market, where rivals such as Advanced Micro Devices Inc. have made big inroads. Such machines account for more and more of the market, but they require cheaper microprocessors that will crimp Intel's earnings. On top of that, Intel is feeling the Asian flu. "The Asia crisis is extending, and it has affected us," says Andy Bryant, Intel's CFO. "Our growth rate is slowing." On average, analysts expect Intel earnings to fall 17% in the third quarter, and Thomas P. Kurlak, an analyst with Merrill Lynch & Co., says the company could wind up reporting a 22% drop in net income for the third quarter, to \$1.2 billion, on a 3% decline in sales, to \$5.9 billion.

SKITTISH. Makers of semiconductor equipment feel their customers' pain. Intel is scaling back its \$5 billion capital-spending plans by as much as 10%. "Many chipmakers worldwide have stopped investing while they reassess their positions," says James C. Morgan, chairman of Applied Materials Inc., the world's No. 1 supplier of chipmaking equipment. Complicating that process, he adds, is the volatility in global stock markets. Because semiconductors are the most capital-intensive products around, plunging share prices make chipmakers skittish. Until that changes, Morgan says, the outlook for chip equipment remains bleak.

Despite all this, however, industry executives—and many analysts—remain bullish about long-term growth prospects. In that respect, the overall picture hasn't changed: High tech will continue to be the fastest-growing, most dynamic driver of the economy. The question is whether high-tech companies can work through their own near-term problems quickly enough to save the U.S. from the global malaise.

By Paul C. Judge in Boston, with Peter Burrows and Andy Rheinhardt in San Mateo, Calif., Otis Port in New York, and bureau reports

HIGH TECH ON A SLOW TACK?



DATA: SEMICONDUCTOR INDUSTRY ASSN., PIPER JAFFRAY COS., SALOMON SMITH BARNEY, DATAQUEST, BUSINESS WEEK

*WIRELESS INFRASTRUCTURE, TRANSMISSION SWITCHING, AND DATA COMMUNICATIONS EQUIPMENT, SUCH AS ROUTERS

By Michael J. Mandel

IS AMERICA WHERE THE GROWTH IS?

Chaos in Russia, depression in Japan, troubles in Brazil. All around the globe, countries are flirting with economic disasters—and policymakers are trying to avoid a global meltdown that could pull the U.S. into recession as well.

Against this backdrop, U.S. corporate execs and investors may want to rethink some basic assumptions. For many years, the conventional wisdom has been that foreign growth would be the driving force for profits and returns in the future. The U.S. was characterized as a "mature" economy, with limited growth potential. By contrast, the emerging markets were supposed to offer rapidly expanding demand from a growing population and enormous investment opportunities.

Well, guess what? So far in the 1990s, it hasn't turned out that way. Since 1993, foreign trade has cut about 0.4 percentage points off annual gross domestic product growth, rather than adding to growth, as many analysts expected. Over the same stretch, domestic profits have risen by 84%, outpacing a 79% increase in profits from overseas operations, as measured by the Commerce Dept. And the U.S. stock market has left its foreign counterparts in the dust, even before the Asian crisis and emerging-markets meltdown. From fall, 1993, to the start of 1998, the Standard & Poor's 500-stock index rose 111%, while the rest of the world's stock markets rose only 33%, according to Morgan Stanley Capital International.

Part of the difference was unanticipated weakness abroad. But more important, the U.S. economy has turned out to be much more dynamic than most forecasters expected—more growth, bigger productivity gains, stronger wage increases, better profitability. For example, one

1993 forecast projected that corporate operating profits, adjusted for inflation, would rise by only 4% over the next five years, and real wages would fall. It turned out that real profits rose by 55% and real wages jumped by some 4%, helping to fuel a larger-than-expected increase in

in the price of cars may be bad news for U.S. auto makers, but for consumers it makes more money available to spend on such items as recreation and computers, driving up profits elsewhere in the economy.

To be sure, this belief in the long-term strength of the U.S. economy

is still a minority view among both economic forecasters and corporate strategists. Most economic forecasts still call for slow growth at home and rapid growth abroad in the long run, despite the latest upheavals. Consider Standard & Poor's DRI's latest forecast, which forms the basis for many official and corporate projections. According to DRI, domestic GDP will grow at only a 2.3% rate over the next five years and personal consumption will grow at the same anemic pace. Meanwhile, real foreign consumption, despite the recent woes, is projected to rise at a sprightly 2.9%.

GLOBAL BETS. Most corporate execs also remain committed to overseas expansion despite the dangers. Take Corning Inc.,

the world's largest maker of fiber-optic cable. Even though the Asian recession has forced down the price the company can charge for its optical fiber as much as 30% and hurt its margins, CEO Roger G. Ackerman believes that, long term, "there is tremendous growth in Asia." Gillette CEO Alfred M. Zeien also figures that emerging markets will eventually resume growing at a rate "higher than anywhere else in the world." Wal-Mart Stores Inc., meanwhile, is acquiring four stores and six undeveloped sites in Korea. "It's a good time to establish a position in the market," says J.J. Fitzsimmons, Wal-Mart's senior vice-president for finance.

They may be right. But for the past five years, it has been a mistake to bet against the U.S. economy—and it shouldn't be counted out now.

Mandel is BUSINESS WEEK's economics editor.



NO PLACE LIKE HOME?

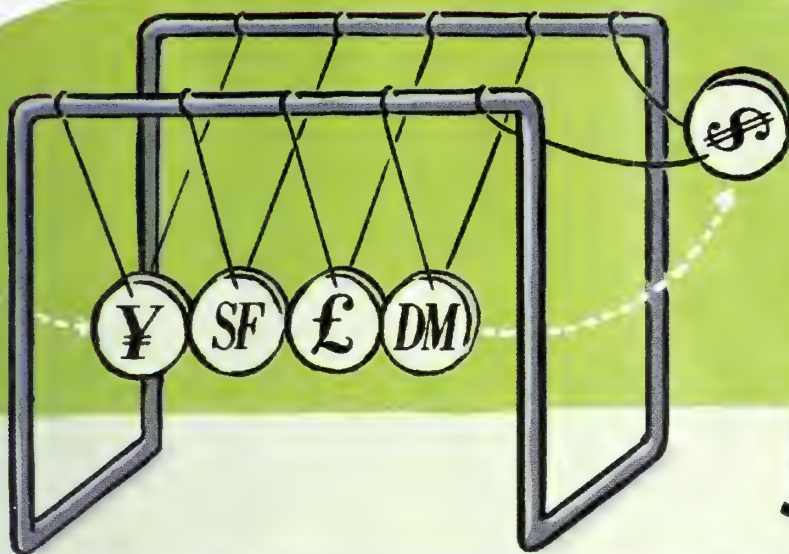
The assumption that the U.S. is too mature to see strong leaps in demand, while overseas markets are where the action is, may be wrong

consumer spending.

Now, the question is whether this strong performance—characteristic of the so-called New Economy—will continue. If it does, that changes the strategic calculus for corporations,

which may conclude that the best opportunities for expansion may well be at home rather than abroad. It also suggests that troubles overseas, as long as the global financial system doesn't implode, may have less effect on corporate profits and the U.S. stock market than expected.

Even what looks like an overwhelming flood of cheap imports could turn out to be a real plus. The fundamental theorem of free trade says that except under unusual circumstances, a fall in the price of imports can only help a country. A fall



ECONOMICS

IS THE GLOBAL CURRENCY CRISIS GREEK TO YOU?

Here's a guide to capital controls, currency boards, and the like

Trading in the Malaysian ringgit accounted for 0.1% of the roughly \$1.5 trillion in currencies traded last year. So Malaysia's Sept. 1 move to restrict ringgit transactions should have produced barely a ripple in world markets. Instead, investors everywhere fretted that other nations would follow suit. With any currency move likely to set off actions around the globe, it's no wonder terms such as currency contagion, capital controls, dollarization, and currency boards have entered our lexicon. What they signify can be confusing. Herewith, some clarification:

What is "currency contagion"?

Once, currencies were bought and sold mainly to finance international trade and long-term investment. Money did flow freely across borders: Most countries fixed exchange rates against a gold or dollar standard, and controls on capital flows were common. Over the past two decades, though, global finance has been untethered. Most exchange rates are not fixed but float freely—although central banks sometimes peg or manage rates. Many governments have eased restrictions on capital and welcomed foreign investors. And while exporters and importers still buy curren-

cies, it is investors who propel the markets, swapping currencies to buy stocks and bonds or placing huge bets on the movement of different currencies.

In good times, investors' bullishness buoyed markets. But contagion works in reverse, too: With few exits barred, global capital fled many Asian economies over the past year, forcing governments to risk recession as they raise interest rates to attract foreign capital.

So what are capital controls, anyway, and would they counteract contagion?

Capital controls come in two flavors: bitter and bitterer. Less onerous controls usually involve taxing short-term capital flows. Chile, Colombia, and other countries use them to discourage "hot money"—fickle investments that flow in and out on a whim. Ironically, at a time when other nations are contemplating controls, the Chilean government in July declared short-term flows less of a threat and cut the tax on foreign deposits under one year's duration to 10% from 30%.

More onerous are

controls such as Malaysia's, which curb foreign exchange transactions in an effort to wall off the economy. The idea was to allow Malaysia to follow domestically oriented policies. In fact, interest rates fell, and after an initial sell-off, the Malaysian stock market recovered.

Does that mean controls should be adopted?

Certainly, hot money affects small economies. A vocal—and growing—minority of economists now suggest that controls on short-term flows might be useful, provided they are temporary and not subject to abuse—a fairly tall order.

More restrictive measures, such as exchange controls, are still more problematic, especially because they can shut off foreign investment.

Just what is dollarization?

In certain countries where inflation is running high, the dollar has become a parallel or second currency, widely—but illegally—used for private transactions. Russians hold an estimated \$40 billion in greenbacks. Such dollarization could ease the adoption of a currency board, though.

O.K., so what's a currency board?

Currency boards have worked in places such as Argentina to stave off hyperinflation by cinching the monetary system into a straitjacket. Boards, which may have non-national representatives, supersede central banks. The domestic currency is backed by foreign reserves and fixed against the dollar. There's no way to counteract recessions, but prices are stabilized and fiscal measures may be taken to shore up the economy.

Currency boards are meant to be free of political interference to ensure their credibility. It's difficult to see that happening in countries verging on economic chaos, such as Russia. Indeed, keeping

politics out of global finance may be impossible. These days, world leaders feel the need to do something—almost anything—to guard against the tidal waves of global capital.

By Karen Pennar
in New York

Once-arcane
economic terms
have quickly come
into common usage

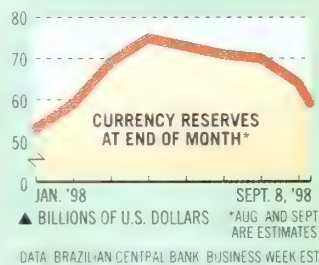
BRAZIL'S ILL WINDS

A recession could spread throughout Latin America

Pedro Malan's image on the TV screen perfectly reflected the somber mood of a country battered by global financial markets. Dark-suited and weary-looking, Brazil's Finance Minister announced \$10.8 billion in painful budget cuts on Sept. 8. Four days earlier, the Central Bank had raised interest rates by 10 points. That's not exactly voter-friendly news with national elections looming on Oct. 4. But the economy in Brazil is facing desperate times once again. And President Fernando Henrique Cardoso had to do something substantial to stem the exodus of money and convince investors he is committed to defending Brazil's currency, the real.

As the region's biggest economy, Brazil is the Latin lightning rod for the financial storm triggered by Russia's default and the bankruptcy of much of Asia. If fleeing capital forces Cardoso to devalue the real, other Latin countries—starting with Argentina—will come under intense pressure to follow suit.

BRAZIL'S SHRINKING RESERVES



The result could be economic turmoil throughout the region, wiping out much of the progress toward economic stability achieved in recent years. Multinationals would reconsider their ambitious investment plans for Latin America. And U.S. hopes of forging a prosperous hemispheric free-trade partnership would dim, possibly for years to come.

CATCH-22. Even if Cardoso manages to keep the real afloat, the cost will be a sharp economic slowdown, very possibly a recession. Brazil's downturn would stifle the economies of such trading partners as Argentina. That, in turn, could transform the emerging-market crisis into a palpable drag on the U.S.

Brazil is already slowing. High interest costs, now 30% for the Central Bank's key lending rate, and proposed deep cuts in government outlays are depressing corporate investment and consumer spending. Marcelo Carvalho, economist for J.P. Morgan & Co. in São Paulo, forecasts a 2% shrinkage of Brazil's gross domestic



product in 1999, down from previous projections of 2% growth. For all of Latin America, Morgan is now predicting 0.8% next year, revised downward from 3.4%.

The catch-22 in Cardoso's game plan is the sharp increase in the cost of financing Brazil's \$260 billion domestic debt. Proposed spending cuts to rein in the government's huge budget deficit, equal to 7% of GDP, are "palliative steps that it hopes will hold until the elections," says Carl Weaver, São Paulo-based head of Brazil research for Banque Paribas. "But it's not clear whether it will be enough." Growing worries over Brazil's shaky finances have sent capital fleeing, cutting Brazil's

FEELING THE SQUEEZE IN MEXICO

Until a few weeks ago, autos made by Ford, Nissan, and General Motors were selling in Mexico like tacos at a fiesta. The reason: zero-interest payment plans offered through Mexican dealers. But when the shock from Russia's default doubled Mexican interest rates, to 40%, auto makers could no longer afford the incentives. In

early September, they scrapped the deals and lowered sales forecasts. Still, even with annual projections scaled back by 9%, carmakers are expected to sell close to 610,000 autos in Mexico this year, compared with 503,000 in 1997.

That's a good summary of where Mexico stands: The global meltdown has meant slower growth but not economic crisis so far. True, the Mexican peso has been pummeled, and the country's interest rates have shot up. But after toeing the fiscal line since its disastrous 1994 devaluation, Mexico is in better shape than other emerging markets, including Brazil. Mexico has a budget deficit of 1.25% of gross domestic product, com-

pared with Brazil's 7%. And while oil prices are hurting the economy, Mexico has chopped federal spending by \$1 billion this year to compensate. Meanwhile, through NAFTA, Mexico has full access to the U.S. market as its own domestic market slows—a big advantage over other emerging countries.

"CLOSED MARKETS." Given these positives, Finance Minister José Ángel Gurría Treviño predicts the economy will grow about 4.5% this year, down from the government's earlier target of 5%. That's likely even though the falling peso is expected to push inflation up to 17%, government economists argue.

Outside the government, assess-



Slower global growth and the costs of financing its \$260 billion debt are crippling domestic growth

perinflation. Supermarket prices dropped a head-turning 1.4% in just the last week of August. Overall, consumer prices fell 1% for the month, the lowest in the 45 years in which records have been kept. Price deflation and rising financing costs could quickly lead to layoffs and more economic strife.

Until recently, a major strength of Brazil has been its attraction for foreign direct investment. But economists are already predicting that this year's \$20 billion inflow will not be matched in 1999, despite recent commitments by companies such as Dell Computer Corp. and Caterpillar Inc. to expand in Brazil.

Can Brazil right itself and save the other dominoes? Cardoso will have to persuade a reluctant Brazilian Congress to accept his cuts and enact reforms of Brazil's bloated public payrolls, social security system, and inefficient tax structure. And for that, he'll need a strong popular mandate in October. Unfortunately, high interest rates and increased unemployment have never been a great recipe for political popularity.

By Ian Katz in São Paulo

currency reserves to an estimated \$59 billion in early September, from a peak \$75 billion last April.

What's clear is that Brazilian business is already headed for the bunkers. Auto makers, a key sector, have already tightened credit terms. General Motors Corp.'s Brazil unit, which exports 20% of its output, has cut back production because of reduced demand in such markets as Venezuela and Russia. Brazil Realty, a real estate developer partly owned by U.S. financier George Soros, has postponed construction of four apartment projects, fearing that higher interest rates will hurt demand. The weaker economy will eliminate scores of

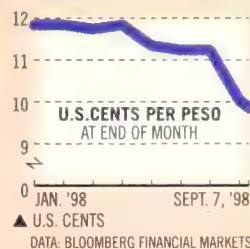
companies, from steelmakers to electronics stores. "Only the best will stay around," says Zeke Wimert, chairman of the American Chamber of Commerce in São Paulo.

The impact of Brazil's slowdown is already spreading. In Argentina, which sends 30% of its exports to Brazil, forecasts of 6.5% GDP growth this year and 5% in 1999 have been cut to 4.5% and 3.7%. Fiat's Argentine unit, which has 200,000 cars sitting in Brazilian ports, will halt production for seven days this month as Brazilian demand dries up.

Now, looming beyond Brazil's slowdown, is the specter of deflation in a country notorious, not long ago, for hy-

perinflation. Banco de México's survey of 25 analysts in August showed 77% think Mexico's economic outlook is favorable—down from 77% in July. Only domestic inflation is topping 40% annually. And would-be borrowers, such as construction company Oribasa, industrial conglomerate Industrias and textile exporter Pliana, have already canceled hundreds of millions of dollars of bond issues in international markets as costs

MEXICO'S SINKING PESO



there, too, become prohibitive. "For practical purposes, the markets are closed," complains Gurría, because international lenders are demanding "ridiculous spreads" of 800 to 1,500 basis points over the interest rate on U.S. Treasury bonds.

SHOPPER SLUMP. The biggest worry is a slowdown in consumer spending—the main engine of growth until now. Retailers such as Grupo Elektra are bracing for such a slump. Elektra, which sells most of its merchandise on

credit terms as long as 43 weeks, is stocking cheaper goods such as smaller-screen TVs. With 721 stores in Mexico, Central America, and Peru, Elektra has also decided to delay a planned move into Chile. Despite the credit squeeze, most analysts believe Mexican companies should make on-time payments on about \$4.3 billion in hard-currency debt over the next 16 months. The government also has plenty of reserves—\$30 billion—to cover bills coming due. So Mexico's challenge is to ride out the immediate storm, while persuading investors that it's different from its neighbors.

By Geri Smith, with Elisabeth Malkin, in Mexico City

COMMENTARY

By Dean Foust

GREENSPEAK: WHEN RHETORIC CREATES REALITY

In less tumultuous times, Federal Reserve Chairman Alan Greenspan's ponderous speech about the New Economy in Berkeley, Calif., on Sept. 4 would have attracted little attention outside economic circles. But with world financial markets churning, Greenspan knew he would have a huge audience. So he inserted two paragraphs at the start of his address to assure investors that the Fed was prepared to come to the aid of the U.S. economy should it be sucked into the global maelstrom.

Greenspan never said what the Fed would do—or when. But that didn't stop traders from concluding that a rate cut was in the bag—sparking explosive rallies in Asia and Europe, and a record 381-point gain in the Dow Jones industrial average when Wall Street reopened on Sept. 8. And the Bank of Japan's move to cut rates the next day fanned speculation that a synchronized easing by the Fed was in the offing.

BIG CHANGE. The markets once again have gotten ahead of the Fed, moving on Greenspan's words, not on Fed actions. True, there was a marked change in Greenspan's tone since July, when he said the Fed was leaning toward an interest rate hike to cool a robust economy which remained—it seemed—unaffected by Asia's deepening distress. Now, with fears that the financial contagion overseas would infect the U.S., Greenspan felt compelled to rule out an imminent rate hike and open the door to an easing of monetary policy.

But Greenspan's carefully hedged pledge to “consider carefully... ongoing developments” suggests the central bank will need to see more signs of a weakening economy before cutting rates. “Greenspan didn't promise a rate cut, although that's what the markets wanted to hear,” says Joel Prakken, a St. Louis-based economist.

The Federal Open Market Committee's next move “is going to depend on the incoming data, and the domestic data haven't shown convincing evidence of a slowdown.”

Nobody should be surprised that traders, investors, and economists made the most—and perhaps far too much—of Greenspan's Sept. 4 speech. It's the latest example of how the Fed

Street, traders decided a rate hike was in the offing. The result: The Dow plunged as much as 162 points the next day. But the Fed's only monetary response was to nudge up the federal funds rate—the rate for overnight loans between banks—by a modest quarter of a point three months later. That rate hasn't moved since March, 1997. “The Fed had a bias to tighten most of the time for the past 18 months—but didn't,” notes G. David Orr, chief capital markets economist for First Union Corp. The markets figured that out too, and stocks

headed for new highs. Greenspeak isn't always aimed at the public, either. Greenspan's latest comments may have been intended for hawks on the Fed who—until recently—have been pressing for a rate hike to ward off inflation. The chairman has been far more worried about Asia's potential drag on the economy. Greenspan recently told confidantes he was relieved the Fed barely avoided a hike last spring. The Berkeley speech suggests Greenspan is “publicly lobbying the hawks to think about the possibility of a rate cut,” says David D. Hale, an economist at Zurich Kemper Investments Inc.

Will Greenspan have to follow up his words with action—a cut at the Sept. 29 FOMC meeting? His comforting rhetoric may have slowed a sickening slide in the stock market. And by bolstering investor and consumer confidence, Greenspan may help keep the economic expansion going without a stimulative rate cut. The lesson for investors who bet on interest-rate moves: Watch what Alan Greenspan does, not what he says. Talk can be cheap, even if it comes from the mouth of the chairman of the Federal Reserve.

Foust covers the Fed.



Greenspan wonders rhetorically whether an “irrational exuberance” is building in U.S. stocks

In Humphrey Hawkins testimony, Greenspan hints that a rate hike is in the offing

Appearing before Congress, Greenspan warns the economy is on an “unsustainable track”

Says Fed is shifting focus from inflation to the risk that the global crisis would slow the U.S.

chief uses his opaque public utterances to carry out a virtual monetary policy—or what Michael R. Englund, chief economist for Standard & Poor's MMS, calls Greenspan's “open mouth policy.” The Fed has barely changed interest rates since 1995, yet throughout that time Greenspan's carefully timed rhetoric has sent stock and bond prices soaring and plummeting.

When the Fed chairman mused in December, 1996, that “irrational exuberance” might be building on Wall

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THE CASE OF THE MISSING PC MAKERS

Why Justice couldn't persuade any to testify against Microsoft

For years, high-tech circles have been abuzz with Paul Bunyon-size tales of Microsoft Corp.'s power and the aggressive tactics Chief Executive William H. Gates III employs to get his way. Now, in its landmark antitrust case against Microsoft, the Justice Dept. is attempting to prove that these were not just computer-industry legends about a mean-spirited bully but proof of Microsoft's anticompetitive behavior to extend its monopoly.

But just when they need computer execs to come forward with stories to bolster their case, the feds aren't getting much cooperation. Justice's witness list for the upcoming trial, released on Sept. 4, contains a cross-section of high-tech corporate icons. But conspicuously absent are the most obvious victims of alleged Microsoft coercion—PC makers who are the most important vehicle for Microsoft products to consumers. Microsoft's efforts to prevent manufacturers from shipping rival products have been a cornerstone of the antitrust action against Microsoft, but the only PC maker to take the stand—Compaq Computer

Corp.—is testifying for Microsoft. "That's the big hole," says Rich Gray, an antitrust attorney with Bergeson, Eliopoulos, Grady & Gray in San Jose, Calif.

So does that mean the Justice case is weak—or that PC manufacturers have no complaints? Not necessarily. Some industry insiders contend it is the very power Justice seeks to curb that has left it without certain key witnesses. "Nobody in the PC business wants to be near this," says one former PC company CEO.

What it means, adds Gray, is that "they couldn't find anyone brave

enough to come forward and risk the wrath of Microsoft."

Even giant Compaq is careful not to offend. A source close to the No. 1 PC maker says that two years ago Microsoft pressured it to undo a deal with America Online Inc. that would have featured AOL's opening screen before Windows. Microsoft threatened, and Compaq backed down, the Compaq source says. Then, Compaq marketing execs argued that a fight with Microsoft was not worth it. The PC maker has also attested in depositions to Justice that Microsoft applied pressure when Compaq attempted to put Netscape Communications Corp.'s Web browser on its desktop with Windows. Now, however, Compaq is on Microsoft's witness list and not Justice's.

CROSSFIRE. Privately, government officials confirm that because Justice could offer no real protection, PC makers were reluctant. No company wanted to be singled out, and attempts to band together fizzled. In May, Compaq, Gateway, Hewlett-Packard, Sony, and Packard Bell had scheduled a meeting with Justice. One by one, they dropped out, each concluding that the group was not big enough to protect against retaliation. The meeting was canceled.

Also missing from the Justice witness list are executives from Sun Microsystems Inc. and Apple Computer Inc., both of which figure prominently in court filings. The government alleges that Microsoft tried to stifle Java, the Sun programming language. Thanks to a private suit brought by Sun, Justice has access to considerable evidence to back its case, making executive testimony less necessary. In contrast, the omission of Apple is less clear. Here, Justice suggests Mi-

KEY JUSTICE WITNESSES...

SCOTT VESEY at Boeing may testify about how Microsoft pressured the company to abandon Lotus' E-mail software, even after it had scored highest in the aircraft maker's technical evaluations.

STEVEN MCGEADY, a vice-president at Intel, will likely be asked about a meeting in which Bill Gates pressured Intel to cease certain software development projects and withhold support for Sun's Java.

JAMES BARKSDALE, president of Netscape, will be asked about a 1995 meeting where Microsoft allegedly tried to persuade Netscape to leave the Windows browser market to Microsoft.

...AND CONSPICUOUS OMISSIONS

PC MAKERS Despite extensive efforts to investigate dealings between Microsoft and PC makers, Justice has not called any to testify. A witness from IBM, John Soiring, does not work for its PC division. Instead, he is expected to testify about competing with Microsoft in operating systems.

APPLE COMPUTER Papers filed by Justice cite Microsoft's dealings with Apple as key evidence of its attempts to stifle competition from Netscape's browser and Sun Microsystem's Java.

BILL GATES is at the center of Justice's allegations. But beyond his depositions, neither side is expected to call him as a witness.





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Microsoft may have pressured Apple, in which it invested \$150 million, into shipping its Internet Explorer browser, rather than Netscape's. It also claims Microsoft tried to persuade Apple not to offer competing multimedia software.

Microsoft denies that it threatens companies that attempt to defy it or that it retaliates against those that do. But such companies have a way of getting caught in the crossfire. Ask Rob Glaser, the CEO of RealNetworks Inc., a startup that makes software for sending video over the Internet. On July 24, Glaser, a former Microsoft exec, testified at Senate Judiciary Committee hearings that Microsoft placed a bug in a rival Windows program that "broke" RealNetworks' software. (A similar charge was made by Caldera, the owner of DR-DOS, which filed a private suit against Microsoft.) Microsoft denied the charges, setting off a public spat between Glaser and Microsoft. In its wake, RealNetworks' shares plunged 25%, from \$44 on the day of Glaser's testimony to \$33 the day after.

That lesson was not lost on other industry execs. "The biggest fear is not of Microsoft, but of your own shareholders and board members," frets Luis F. Machuca, executive vice-president for Packard Bell NEC Inc. "This thing with RealNetworks is a huge windfall for Microsoft. It will have a chilling effect."

MEMORY LAPSES. That's not good news for Justice, which needs all the ammunition it can gather to bring its broadened monopolization case. Unless Justice swaps in a PC witness before the trial, it will have to rely on subpoenaed depositions and contracts—and on testimony by such Microsoft competitors as AOL and Intuit.

Neither the government nor Microsoft has called the most intriguing witness: Gates. After deposing the billionaire chairman in August, Justice lambasted his "astonishing lack of recall." For its defense, Microsoft will rely on midlevel execs it says were most directly involved in the alleged incidents cited by Justice—allowing Gates to duck cross-examination.

Microsoft, meanwhile, is still seeking the case's dismissal. It's also contesting what it calls an 11th-hour shift in Justice's case, and U.S. District Judge Thomas P. Jackson on Sept. 17 will rule on whether the expanded evidence is admissible. If it is, which experts say is likely, then Microsoft could seek a delay of up to six months to prepare its defense. In that time, more tall tales are likely to be told. The question is: Will anybody be willing to tell them to the judge?

By Amy Cortese in New York, with Susan B. Garland in Washington and Steve Hamm in San Mateo, Calif.

COMMENTARY

By Stan Crock

STAR WARS JR.: PRICEY PIE IN THE SKY?

India and Pakistan set off nuclear blasts in May. Iran launched a medium-range missile in July; North Korea followed suit on Aug. 31. And chaos in Russia could put its nuclear arsenal at risk of being peddled for hard cash. There's no question that the world suddenly looks like a much scarier place.

Even so, does it make sense to accelerate the deployment of a scaled-down version of Ronald Reagan's Star Wars missile-defense system? GOP leaders think so. And while they couldn't force a vote on the \$18-billion Star Wars Jr. program in the Senate, it appears likely to pass the House, providing an opportunity for a second try in the Senate.

TOO HURRIED? Despite the worrisome developments around the globe, rushing technology into development before it has been thoroughly tested is a mistake. Currently, the Clinton Administration plans to do two more years of research and development and then make a decision on whether to deploy by 2003. Even that schedule, both a Pentagon study and a report by the General Accounting Office insist, is too hurried.

As with the original Strategic Defense Initiative, the critical question is: Can this technology work? Admittedly, the mission to develop the currently contemplated system, being attempted by Boeing Co., isn't as daunting as Reagan's vision of a shield against thousands of intercontinental ballistic missiles launched by the Evil Empire. This version is supposed to protect the U.S. from a handful of such long-range missiles fired by a rogue state.

That's still the equivalent of hitting a bullet with a bullet. And so far, the

technology is proving difficult to develop. Take Lockheed Martin Corp.'s Theater High-Altitude Area Defense (THAAD) system, an even smaller-scale attempt. Designed to defend troops in the field against 1,000-mile-range missiles, THAAD has failed in five straight tests. The Pentagon is considering whether to suspend the program. The proposed national defense

system would have to be able to hit a missile traveling 15,000 miles an hour, twice as fast as some theater missiles.

Finally, some experts wonder if Star Wars Jr. can defend against the most likely threat. They argue that the weapon of choice for rogue states will

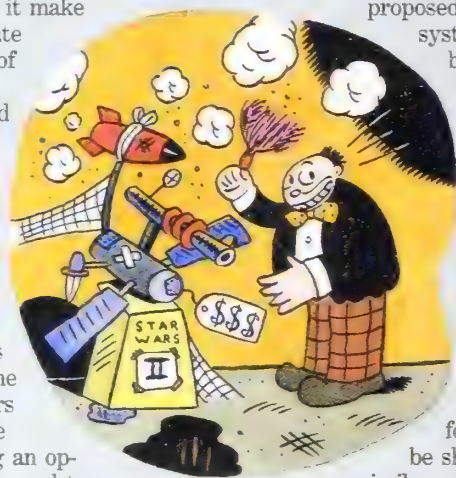
be shorter-range cruise missiles—making even a working Star Wars Jr. useless.

Moving prudently has not deprived the project of necessary appropriations, either. As it stands, Washington is spending \$1 billion annually to develop the system, and a decision to deploy sooner would probably not dramatically affect that number. What such a decision would do, however, is limit the U.S.'s options on pursuing alternative technology.

On the foreign front, the GOP must also consider the 1972 Anti-Ballistic Missile Treaty with Russia. Voting to deploy Star Wars Jr. would be a disavowal of the treaty at a time when the U.S. is trying to get Russia to sign new arms-control measures on its nukes: the biggest threat the U.S. faces.

Rapid deployment of a missile defense is an admirable goal—and a comforting thought. But hurrying development of a flawed Star Wars will provide only illusory protection. After all, this is rocket science.

Crock covers national security issues in Washington.



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TELECOMMUNICATIONS

FOR LUCENT, HUNTING SEASON IS ABOUT TO BEGIN

Its targets: Networking companies and foreign partners

Even in the red-hot telecom-equipment market, Lucent Technologies Inc. has been a star. Still, CEO Richard A. McGinn hasn't hesitated to point out Lucent's weaknesses, conceding that it needs to offer better gear for data networking and participate more aggressively in overseas markets. The simple solution would be to buy companies that fill those strategic holes.

Until now, however, McGinn has been limited in his ability to do that. Despite Lucent's soaring stock, up sixfold to \$80 a share since its public offering in 1996, the company hasn't been as free as rivals such as Cisco Systems Inc. to use its shares as acquisition currency. The reason: Accounting rules bar spin-offs such as Lucent—formerly a unit of AT&T—from using an accounting method called “pooling of interests” for deals until they have been independent for two years. Pooling lets companies avoid taking charges against earnings to write down “goodwill”—the price above book value they pay. Lucent's second birthday is Oct. 1.

PLUGGING HOLES. So what will Lucent buy itself as a gift? The company won't comment. But investors and analysts are buzzing about possible targets, including networking-equipment maker Ascend Communications, France's Alcatel, and Finland's Nokia. With a market capitalization of more than \$100 billion, Lucent could pull off deals that would set records in an industry already marked by merger mania. Targets could include Ascend, with a market capitalization of \$9 billion, or even Nokia, valued at \$48 billion. “Everybody's sort of holding their breath to see what Lucent will do,” says William Schaff, chief investment officer at San Francisco-based Bay Isle Financial Corp., a Lucent shareholder.

Lucent is actively looking at networking and international deals, according to two investment bankers who have talked to company executives. William O'Shea, the head of Lucent's

data-networking group, is spearheading the networking initiative. Ben J.M. Verwaayen, Lucent's co-chief operating officer, is trolling for global deals. Lucent has used Goldman, Sachs & Co. or Morgan Stanley Dean Witter for big deals in the past but does not have an exclusive investment bank this time, the bankers say.

Lucent's most immediate need is for data networking. The market for data gear is growing 25% a year, says BancBoston Robertson Stephens, about double the traditional telecom-equipment market. And Lucent is weak in two fast-growing areas: asynchronous transfer mode (ATM) and Internet protocol (IP) routing technology.

That's where Ascend comes in. The Alameda (Calif.) company is the market leader in ATM and has some IP routing expertise. “That's not rocket science,” says Mark Dicioccio, a managing director and head of Lehman Brothers Inc.'s telecom-equipment practice. “Ascend is pretty much the last one standing.” Ascend says it plans to remain independent but would listen to an overture. If Ascend

LUCENT'S MOST-WANTED LIST

ASCEND COMMUNICATIONS The \$1.2 billion company would give Lucent additional expertise in the fast-growing market for data networks. The firm would probably cost more than \$10 billion, and Wall Street deems it Lucent's most likely target.

NOKIA The \$9.8 billion Finnish telephone-equipment maker has been a rising star, thanks partly to its wireless technology. It would give Lucent a needed boost in Europe and a presence in a total of 45 countries.

SIEMENS' TELECOM UNIT The German conglomerate, which makes everything from locomotives to medical equipment, has a strong \$16 billion telecom-equipment business.

ALCATEL The \$30 billion French giant offers international reach, with operations in 130 countries. It has bulked up its digital capabilities, notably with its \$4.4 billion acquisition of DSC Communications in June.

DATA BUSINESS WEEK



LIBERTY: McGinn will soon have more freedom to use Lucent shares as acquisitions currency

balks, Lucent could target other networking companies such as Newbridge Networks, the No. 2 ATM player.

Overseas, where Lucent generated only about \$6 billion of its \$26.4 billion in 1997 revenue, bankers say the strongest candidate would be Finland's Nokia Corp. Nokia would give Lucent expertise in Europe's most popular wireless technology and would provide valuable customer relationships in some 45 countries. Nokia declined comment.

Several other companies would also help in foreign markets. France's Alcatel has operations in 130 countries and growing data expertise. But the company, which declined comment, may resist a takeover, and Lucent is unlikely to attempt a hostile deal. Siemens' telecom unit would also give Lucent greater international reach. But a spokesman for Siemens says it would not sell the telecom business on its own.

How soon will Lucent make its move? It can't have substantial negotiations before Oct. 1 without running afoul of accounting guidelines. But McGinn has a head start—the shopping list he has been carrying around for two years.

*By Peter Elstrom
in New York*

DITED BY KELLEY HOLLAND

HE SEC GETS TOUGH ON BONDS

ARTHUR LEVITT JR. IS OUT TO demystify the bond market. On Sept. 9, the Securities & Exchange Commission chairman called for new reporting requirements on every corporate bond transaction. Levitt directed the National Association of Securities Dealers to start a database of all corporate debt transactions, with bond dealers reporting their prices to NASD. This paves the way for entrepreneurs to take the next step: making bid and offer information available through online trading systems. Levitt so is beginning a new surveillance program following the SEC study unearthing abuses, including possible in-

sider trading among bond market players. The Bond Market Assn. has opposed new reporting mandates in the past, but now says it looks forward to working with regulators.

WHAT'S GROUNDING NORTHWEST TALKS

ELEVEN DAYS INTO THE strike at Northwest Airlines, Transportation Secretary Rodney Slater and Deputy White House Counsel Bruce Lindsey on Sept. 8 tried to jump-start talks between the pilots' union and the company. But it won't be easy. For one thing, numerous protégés of corporate raider and union nemesis Frank Lorenzo now hold senior positions at Northwest. Chief negotiator Richard Hirst and marketing head Michael Levine worked under Lorenzo in the '80s. And on Sept. 3, Northwest made special projects officer Mickey Foret—who was president of Continental Airlines under Lorenzo—chief financial officer.

A NEW DIESEL ON GM'S EASEL

TEAM EFFORT: GENERAL Motors announced on Sept. 9 a \$320 million joint venture with Isuzu Motors to build a new generation of diesel engines at a new plant in Moraine, Ohio. The venture will give GM a quieter, cleaner V-8 engine for its full-size pickup trucks. The decision to build near an existing GM diesel factory, which will close when the new facility opens in 2000, pleased local workers and their union, the International Union of Electrical Workers, since all 500 workers can keep their jobs. A union official says GM had considered moving the operations to Mexico.

RUPERT MURDOCH

HE SHOOTS, HE SCORES

Manchester United, Britain's richest football club, has accepted a \$1.04 billion offer from BskyB, the satellite broadcaster 40% controlled by Rupert Murdoch's News Corp. He already owns part of the World Football League and the New York Knicks and the Rangers, and he bought the Los Angeles Dodgers this year.

Like Murdoch's other sports deals, this one is aimed at locking up programming. BskyB has thrived on exclusive broadcasts of Britain's Premier league, which includes Manchester United, under



a \$1.1 billion four-year deal that expires in 2001. Paul Richards, an analyst at Panmure Gordon, says Murdoch wants to retain access to the games.

He also wants a say in the shakeup looming in European soccer. A group associated with media mogul Silvio Berlusconi has been wooing Manchester United, and inviting top clubs in each nation to join a new soccer league. Stay tuned.

By Stanley Reed



CLOSING BELL

UP, UP, AND AWAY?

A bit of good news after a lot of bad can do wonders for a stock. After falling 44% from its July, 1997, peak, shares of Boeing have soared 14%, to 35½, since Aug. 31. Some of the credit goes to a Sept. 1 management shuffle, including appointing a new president for Boeing's commercial aircraft division. Boeing also said between Sept. 7 and 9 it had more than \$5 billion in new jet orders from Varig, KLM Royal Dutch Airlines, and three big leasing companies. Analysts say the stock could hit 66 within a year.



AN OFFER FRANCE COULD REFUSE

"MERCI, NON," WAS THE French reply to a bid for state mortgage bank Crédit Foncier de France by General Motors Acceptance Corp. and Texas investor Robert Bass. The Americans were the sole bidders, but France nixed the offer for the \$52 billion bank as too low. That's partly because GMAC had lowered its price to account for 200 billion francs in bonds with shaky guarantees. And French unions opposed the deal, GMAC says. GMAC still plans to expand European commercial mortgage operations and may even bid again on Crédit Foncier.

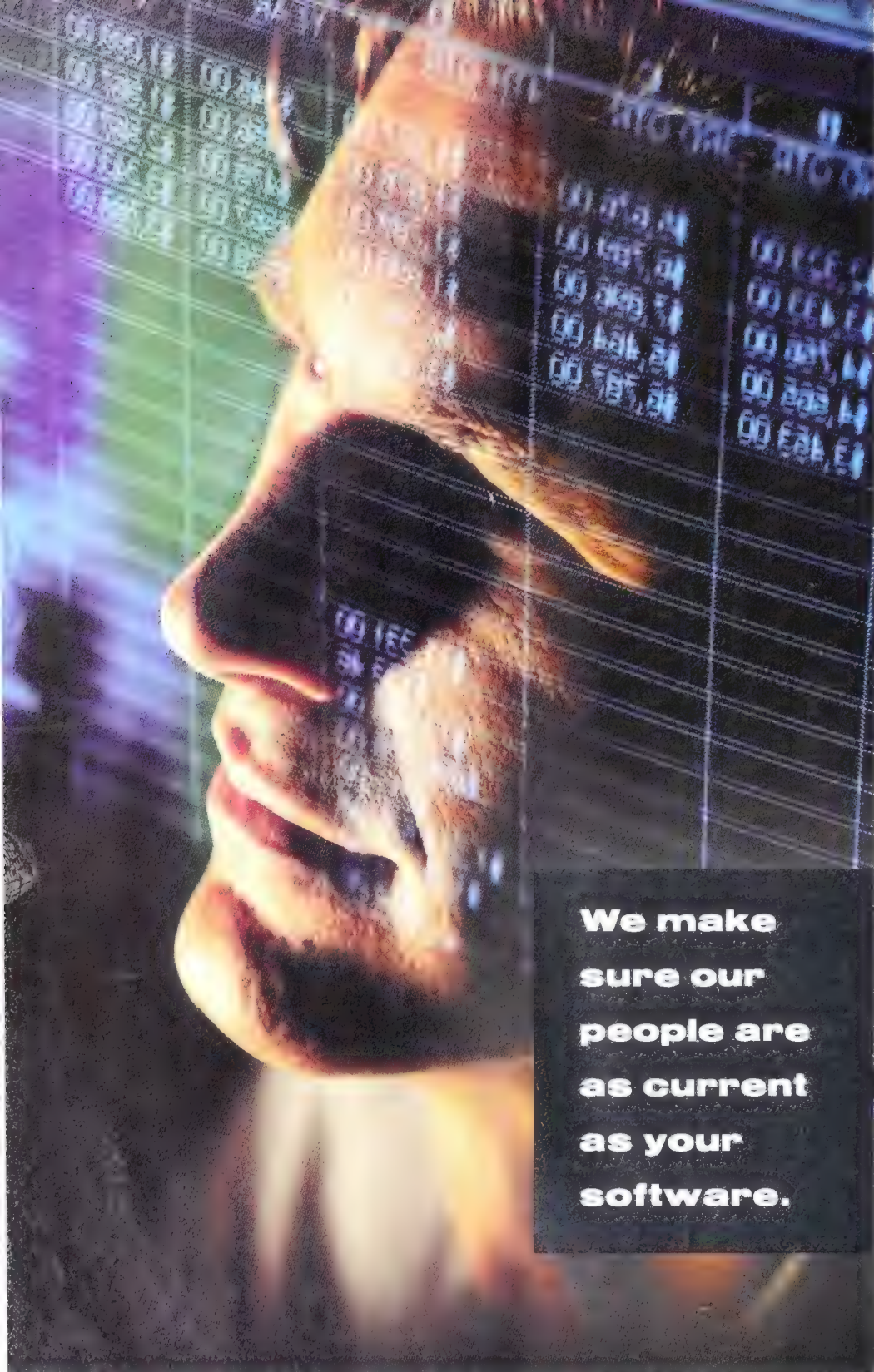
A COMPLETED PASS FOR THE BROWNS

THE CLEVELAND BROWNS have a new owner: Alfred Lerner, billionaire chairman and CEO of MBNA. Offering a

\$476 million franchise fee, a record for the National Football League, Lerner beat out five bidders, including Cablevision Systems' Charles Dolan. Lerner got a boost as NFL owners reviewed the bids on Sept. 8 when Art Modell, who took the Browns out of Cleveland in 1996 and made them the Baltimore Ravens, announced his support. Also helping: Lerner's partner is former San Francisco 49ers head Carmen Policy, well-regarded in the NFL.

ET CETERA...

- Eli Lilly presented promising data on Humalog Mix-25, an upcoming insulin combo.
- Starbucks lite: The company is offering a milder version of its coffee.
- Hilton Hotels ran the first ever ad on the handheld Palm Pilot.
- Equity Inns and RFS canceled their deal, blaming "market forces."



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EDITED BY OWEN ULLMANN

WITH DEMOCRATS DEFECTING AND STARR REPORTING, IS CLINTON A GONER?

Call it sin spin. On Sept. 9, Bill Clinton summoned House Democrats to a White House pep talk designed to spike speculation about impeachment. On the surface, the results were felicitous. After another of his sequential apologies or moral malfeasance, the beleaguered President got Democratic leaders to face the cameras and intone that impeachment talk was premature.

But under this veneer of unity marks spreading Democratic panic. Now that Independent Counsel Kenneth W. Starr has sent Congress a damaging report on alleged White House misconduct, Clinton's Presidency is in jeopardy. Hill Democrats increasingly worry about being dragged down with him.

At best, Democrats hope that GOP attempts to dump Clinton over the tawdry details of the Starr report will spark an angry backlash. To complete this reamy scenario, Democrats' denunciations of the President will enable them to ride out the fall elections with minimal losses.

The worst-case scenario: Vengeful voters spurn Democrats after Republicans turn the election into a referendum on Clinton's morality. That fear is buttressed by a new poll conducted by Republican Ed Goas and Democrat Celinda Lake. It found that moral issues have surpassed crime and education to become Americans' top concern.

If sustained, that could translate into big GOP gains. Republicans could capture a filibuster-proof majority of 60 in the Senate, pick up 15 seats in the House, and increase their hold in statehouses. Potentially, the scandal is "an atomic bomb hitting the party," says Democratic consultant Brian Lunde.

OLICY ROUT. If Armageddon comes, the policy environment in Washington will be radically transformed. In the short run, a weakened Clinton will be in a poor position to bait Republicans into a self-destructive government shutdown. And he will be forced to back away from his opposition to the \$75 billion election-year tax cut Republicans are pushing.

Longer term, if Republicans gain strength in the new Congress, a President struggling to escape the grinding machinery of impeachment will be hard-pressed to push any policy initiatives and win confirmation of key nominees. Suddenly, Republican priorities such as a ban on late-term abortions, faster development of a missile-defense system, and reform of the legal system could gain veto-proof support.

It is this nightmare scenario that is leading some Democrats to distance themselves from the President. And the tougher the race, the greater the distance. Taking their cue

from Connecticut Senator Joseph I. Lieberman's impassioned Sept. 3 denunciation of Clinton's ethics, Democrats are joining the condemnation chorus.

On Sept. 8, Senator Barbara Boxer of California, whose daughter is married to a brother of Hillary Rodham Clinton, branded Clinton's affair with Monica Lewinsky "immoral."

Senator Ernest F. Hollings of South Carolina said he was fed up with the "dishonesty of the President." On the same day, Maryland Governor Parris N. Glendening boycotted a Presidential visit to a Silver Spring (Md.) elementary school.

Clinton wouldn't have to worry so much about his base if his ties to Hill Democrats were stronger. But many still blame him for losing control of Congress in 1994. Other party stalwarts resent Clinton's tactic of playing liberals against GOP conservatives to build support for his centrist "third way." Now that Clinton is in the ethical soup, "there's no loyalty," says one senior House staffer. "This guy made the calculation in January that he could lie and get others to lie for him. No one's willing to stand up for him."

Clinton has more to worry about than mutiny in the ranks. Wall Street's roller-coaster ride has raised the specter of slower growth, layoffs, and a recession. If the economy slips, his ability to wage a two-front war against vengeful Republicans and renegade Democrats will ebb.

Even global crises aren't helping Clinton. Meltdowns in Russia and Asia have critics ranging from Senate Majority

Leader Trent Lott (R-Miss.) to Senator Daniel P. Moynihan (D-N.Y.) questioning whether the President is up to the task of global leadership. Moynihan's answer: speedy consideration of impeachment.

Not all Democrats feel that way, of course. "We're acting like scared bunnies," sighs a top strategist. And Senator Robert Torricelli (D-N.J.) decries the "rush to judgment." Given Clinton's Comeback Kid record, it is probably a bit early to write him off. But if the President's weakness turns into a party rout in November, Democrats will be looking for a fall guy. The search will inevitably lead them to the Oval Office.

By Richard S. Dunham and Amy Borrus



UNWELCOME VISITOR

Maryland protesters mirror a new poll showing that moral issues are now many voters' top concern

MALAYSIA

RENEGADE ECONOMY

Can Mahathir wall off Malaysia?

It all comes down to this: Can you put the genie back in the bottle? Once a country has embarked on the path of free-market capitalism, can it go backward, closing off some of the less desirable effects of market forces, and still attract the foreign capital and investment it needs to grow?

That is the hypothesis now being tested by Malaysia's Prime Minister Mahathir Mohamad. By imposing currency controls—outlawing trade in the ringgit and imposing onerous curbs on foreign stock investors—Mahathir is taking a huge gamble. If he succeeds, he could become a role model for developing nations starting to question the long-held model of economic globalization. And he could ignite a wildfire that spreads to other ailing nations. "If we don't get some help from the U.S., Europe, or Japan, we may have to close up, too," warns Stock Exchange of Thailand Chairman Amaret Sila-on, a leading reform figure.

Mahathir's bet is likely to be a loser. The economy is already in recession, with a 7% contraction forecast for this year. It will be further stunted by heavy-handed administrative controls. At the same time, Mahathir's attempts to reflate the economy could boost imports and thus run down foreign reserves, making devaluation likely and prompting trade restrictions.

A more pressing concern is that Malaysia now won't embark upon domestic re-

forms. Because Malaysia has effectively burned its bridges with foreign portfolio managers, its beleaguered companies will be deprived of an important source of capital to rebuild. By closing off parts of Malaysia's economy, Mahathir may find that he has crossed Malaysia off the world investment map.

GOLD SALES. Mahathir's currency controls aim to relieve the parched economy. He plans to sell off gold holdings, netting about \$500 million, say sources familiar with the plans. He also intends to tap the international bond market for another \$500 million. Regulators have cut banks' reserve requirements for the fourth time, freeing up more money for lending. The government is asking local bankers to extend fresh credits. And interest rates are tumbling, down 1.5 percentage points in early September. "We just want to insulate, not isolate, ourselves from the current turbulence," says Francis Yeoh, managing director of infrastructure developer YTL Corp.

Mahathir thinks he has enough money inside Malaysia to refloat the banks and defy the world. The state-run pension system could devote \$520 million a month to propping up stocks, which have started climbing since the new policy took effect. State-owned oil and gas company Petronas also has cash that could be tapped. A high personal savings rate could play a part, too. But many analysts doubt Malaysia will be able to clean

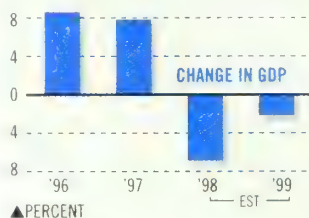


up its banks with local funds alone.

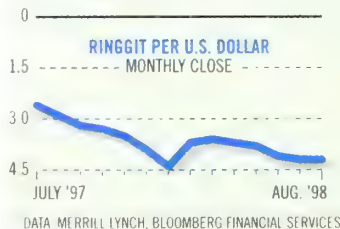
The currency crackdown flows from the assumption that using a big stick can force money back home. One source of Mahathir's ire was rampant futures trading of the Malaysian ringgit in Singapore, which stemmed from his ban on such trading at home. As Malaysia's crisis deepened and the ringgit weakened, more companies rushed to hedge their exposure to the currency in Singapore. Some players were speculators, but financial sources in Kuala Lumpur say that much of it involved prudent business decisions by companies trying to protect against a falling currency. The effect was to suck money out of Malaysia's economy—some \$650 million to \$1 billion. "Such activities created extreme instability," Mahathir's longtime confidant Daim Zainuddin said in a written reply to *BUSINESS WEEK*. Daim was brought in over ousted Deputy Prime Minister and Finance Minister Anwar Ibrahim to run economic policy.

Another risk is that Malaysia will drive away foreign direct investment, which has been the lifeblood of its rapid emergence as an export power and is the key to its economic success. Foreign electronics giants such as Intel, Motorola, and Seagate have invested

MALAYSIA'S ECONOMY IS SHRINKING...



...AND ITS CURRENCY HAS TUMBLED



DATA: MERRILL LYNCH, BLOOMBERG FINANCIAL SERVICES



illions in giant, low-cost industrial parks. They employ hundreds of thousands of workers and account for the nation's share of Malaysia's exports. So far, the government has assured foreign exporters that they can still convert currencies to pay local bills and repatriate their earnings. "As far as we are concerned, this will have minimal impact on our business," says Wong

Siew Hai, managing director of Intel Corp.'s vast operations in Penang, one of its biggest offshore bases for making Pentium II microprocessors and circuit boards. Intel still plans to spend \$400 million on expanding output this year.

Even those who give Mahathir the benefit of the doubt hope that he phases out the currency controls quickly. The worry is that they will become per-

KUALA LUMPUR BROKERS: *Stocks have risen in the wake of the controls*

manent and extend to trade in goods and services as well. Confusion reigns over how Malaysia will authorize currency conversions for exporters. Will it be automatic and electronic? Or will it be cumbersome and bureaucratic? "The new policies are not permanent," said Daim, "but we are following closely what is happening outside Malaysia." He declined to comment on reform, insisting instead that "there has been no shift in the economic strategy."

The debate over reform was at the center of the dramatic events that led to Mahathir's successful purge of Anwar. Deputy Prime Minister since 1993, Anwar, 51, had pushed for more openness and less corruption, a freer press and more independent judiciary—especially as the economic downturn started to bite. He wanted to use the crisis to weed out cronies who dominate big companies. But Mahathir favored bailouts, including one for his businessman son. Now, Anwar is under investigation for sensational allegations ranging from sodomy to espionage. "It is not a legal case," insists Anwar. "It is political."

Anwar is not going quietly. "The government has failed to discredit Anwar," says supporter Abdul Rahim Ghouse, pointing to thousands at a local mosque who cheered Anwar after Friday prayers. "These people are usually the first to be convinced of charges of immorality." For the moment, though, Mahathir has discredited free markets. And the world is watching to see if his economics of defiance works.

By Mark L. Clifford and Pete Engardio in Kuala Lumpur

A FIRED FINANCE CHIEF SPEAKS OUT

Finance Minister Anwar Ibrahim was fired by Prime Minister Mahathir Mohamad on Sept. 2 after they clashed over economic policy and political freedoms. Anwar spoke with Hong Kong correspondent Mark L. Clifford. Some excerpts:

On relations with Mahathir:

We had differing styles and emphasis, and differing views on issues like democracy, civil society, and tolerance of dissent. The fall of Suharto and the undercurrent in Malaysia on the issue of corruption aggravated the problem.

On currency controls:

The measures, which were done one day before my dismissal, are very radical and will have serious implications. I agree on the need to check excesses. But to attempt to insulate our economy in its entirety can be damaging.

On globalization:

We are for globalization, liberalization is irreversible, and we have benefited immensely from free-market economics. But there are excesses. We need to reform the international financial architecture.



ANWAR: *Says the curbs are damaging*

RUSSIA

'THE OLIGARCHS HAVE OVERPLAYED THEIR HAND'

How far will Russia's powerful conglomerates tumble?

As power plays go, it turned out to be a terrible loser. When Russia's powerful tycoons arm-twisted Boris Yeltsin into firing his reform-minded government on Aug. 20, they had no idea of the destructive economic forces the move would unleash. The moguls, led by media and auto magnate Boris A. Berezovsky, had been trying to protect their financial-industrial empires from government demands that they pay billions in back taxes—or be forced out of business. Instead of winning breathing space, the tycoons and their businesses are themselves now reeling from Russia's collapsing ruble and mounting political chaos.

Indeed, Russia's tycoons face grave threats to the economic power they have amassed since their empires were created a few years ago. In recent days, three leading banks, including Berezovsky's SBS-Agro, have swooned into effective bankruptcy, and the Central Bank has absorbed them. The conglomerates' oil companies and other industrial holdings can't collect payments due them because Russia's banking system is frozen. And the near-70% drop in the ruble's value since Aug. 17 means the moguls will find it all but impossible to pay back billions in hard-currency loans owed by their subsidiaries. "The oligarchs have overplayed their hand," says an American adviser to one of Russia's top five banks.

The figures are ominous. Rating agency Fitch IBCA says Russia's banks owe a total of \$30 billion to foreign creditors, while its corporations owe an additional \$25 billion. Groups such as Inkombank, SBS-Agro, and Rossisky Kredit are in the deepest trouble: They owe the most to foreigners. SBS-Agro owes more than \$1 billion (table). The banks also hold huge portfolios of Treasury bills, virtually worthless since Russia's default. While some banks, such as Oneximbank, sold their T-bills before the government's move, their oil and other industrial units are barely functioning as a result of the crisis.

RUDE AWAKENING
Berezovsky's SBS-Agro has been taken over by the Russian Central Bank

For all Russia's top banks, the financial crash is a rude awakening. Over the past several years, the banks made easy money on fees, currency speculation, and high-yielding government bonds as Moscow processed much of its budgetary funds through them. In 1995,



TYCOONS IN HOCK TO THE WEST

NAME/ BANK	INDEBTEDNESS (MILLIONS OF DOLLARS)*
BORIS BEREZOVSKY SBS-Agro	\$1,020
VLADIMIR VINOGRADOV Inkombank	855
VLADIMIR POTANIN Oneximbank; MFK	603
DMITRI LUBININ Rossisky Kredit	593
MIKHAIL KHODORKOVSKY Menatep	420
VLADIMIR GUSINSKY Most	128

*ESTIMATED FOREIGN DEBT DATA: PROFIL, BUSINESS WEEK

these favored banks were also allowed to pick up key industrial assets for low prices through a controversial privatization scheme. The banks planned to sell some enterprises to foreign investors for a quick profit, while milking oil and other resource companies for cash. That strategy was dashed this year as global oil prices plunged, biting into profits.

To ease the pain, Berezovsky and banker Mikhail Khodorkovsky, who both own oil companies, pressed the government to engineer a controlled devaluation of the ruble. That, they said, would cut the ruble cost of producing oil in Russia, while boosting export competitiveness. But the ruble fell much further and faster than either the tycoons or the government expected. By Sept. 8, it was trading at over 20 to the dollar—far beyond the band of 9.5 to the dollar the government had hoped to maintain. The ruble's plunge sharply increased the oil companies' cost of servicing debt they had secured from foreign creditors, canceling out any cost benefits.

COZYING UP. Now, the turmoil could shake up the tycoons' empires. With their finances stretched thin, the moguls are likely to focus on their raw materials businesses, unloading other assets. Indeed, the bankers may ask for effective bailouts through nationalizations. Analysts say some tycoons may be willing to sell or give some of their inefficient industrial enterprises back to the government in lieu of taxes—if they can keep hard-currency-generating jewels such as oil and metals companies. Under this scheme, the government would try to keep the renationalized factories open and later sell stakes to Russian or foreign investors.

No doubt, the tycoons will do everything they can to survive. When they pushed for the ouster of Prime Minister Sergei Kiriyenko, the moguls had urged Yeltsin to appoint their ally, Viktor S. Chernomyrdin, as the new Prime Minister. But Russia's Parliament has refused to approve Chernomyrdin. So Berezovsky is now cozying up to populist Krasnoyarsk Governor Alexander Lebed and Moscow Mayor Yuri Luzhkov as alternatives. Meanwhile, analysts assume the moguls have stashed billions in offshore accounts.

How much will Russia's crisis end up hurting the economic elite? As the ruble loses its value, inflation soars, and goods disappear from the shelves, perhaps that's the only silver lining in the cloud for ordinary Russian people: The moguls may be feeling some pain, too.

By Patricia Kranz in Moscow



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COMMENTARY

By Joan Warner

TIGHT MONEY: THE WRONG SHELTER FOR THIS STORM

Anyone who's still wondering whether the economic disaster in Russia and a year of crises in Asia will have a major impact on the world's industrial economies need only look at Europe. All the bad news has made forecasting economic growth there even more hazardous. For the 11 nations that must bring their interest rates to the same level by Jan. 1 to prepare for the euro, the uncertainty couldn't come at a worse time.

But from across the Atlantic, a lifeguard is watching over Europe's troubled waters. When Federal Reserve Chairman Alan Greenspan on Sept. 4 signaled that he had shifted his attention from inflation to growth, he gave the industrialized world the green light to fight deflation by allowing easier money. Japan took the hint, cutting its overnight lending rate to a record low 0.25% on Sept. 9. Europe's central bankers would be well advised to follow suit. **READ HIS LIPS.** Already, the gyrations in world markets have reversed the outlook for where the members of European monetary union will fix their rates at yearend. When stock markets were flying high and growth predictions were sanguine, observers expected Germany's Bundesbank to set a tight-money benchmark for the euro zone. Instead, Europe may face a downturn. Analysts had been expecting a range of 3.5% to 3.75% for euroland's initial interest rate. Now, "we think 3.3% is a better bet," says Elisabeth Waelbroeck-Rocha, chief European economist for Standard & Poor's DRI in Brussels.

That means the Bundesbank, which had been expected to raise rates half a percentage point by yearend, may hang fire. And Bundesbank President Hans Tietmeyer

seems to have read Greenspan's lips, suggesting the central bank will stay neutral for now. There's little reason for him to budge. Inflation in core Europe, discounting a rise in value-added taxes, is near zero. "There is a very strong case to keep rates unchanged," says Eric Chaney, co-head of Morgan Stanley Dean Witter's European economics team in Paris.

A lower benchmark would force Italy, with rates of 5%, and Ireland, with 6.75%, to loosen monetary purse strings even more than anticipated to close the gap. Bank of Italy governor Antonio Fazio is already fretting that his country's money supply is growing too fast. Italian rates are at historic lows. But Italy's economy grew at an annual rate of only 1.2% in the second quarter, down from 2% in the first. So Fazio had better take a leaf from Greenspan's book, as Spain already has. The Bank of Spain plans to lower short-term rates, at 4.75% now, nearly a full percentage point by yearend.

The danger, of course, is that faster-growth countries such as Ireland will court inflation with a drastic rate cut. But if the German economy slows down, so will the rest of

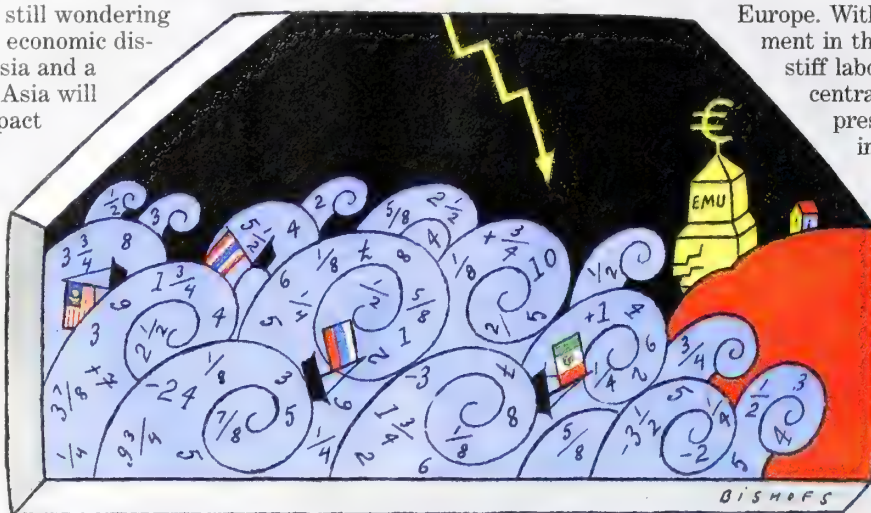
Europe. With high unemployment in the euro zone and stiff labor competition from central Europe, wage pressures are nowhere in sight. In addition, Greenspan has made it easier for Europe to lower its interest-rate threshold by ensuring that higher U.S. rates won't suck money from the Continent.

Easier money won't necessarily mean the euro will be born weak, either. Investors have voted their approval of European monetary policy by treating the Deutschmark—the euro's proxy—as a safe haven. The mark has strengthened against the dollar over the last few weeks. "De facto, a certain amount of money has been flowing into the euro," says John Llewellyn, chief global economist for Lehman Brothers in London. Llewellyn points out that in times of crisis, money flows to countries with few overseas liabilities.

U.S. foreign debt is about 13% of gross domestic product, while Europe is a slight net creditor. America's huge current-account deficit bodes well for the euro's strength.

Credibility will be an issue for the new European Central Bank when it takes over next year. Its governors want it to start life with a tough anti-inflation stance. But choking off growth in the midst of deflation would be a lousy start to EMU. Instead, Europe's central bankers should lay the groundwork for growth that can ride out global crises like today's. All they need to do is watch the lifeguard on the far beach.

Senior News Editor Warner follows Europe's economies from New York.



Europe's central bankers should heed Greenspan and focus on growth

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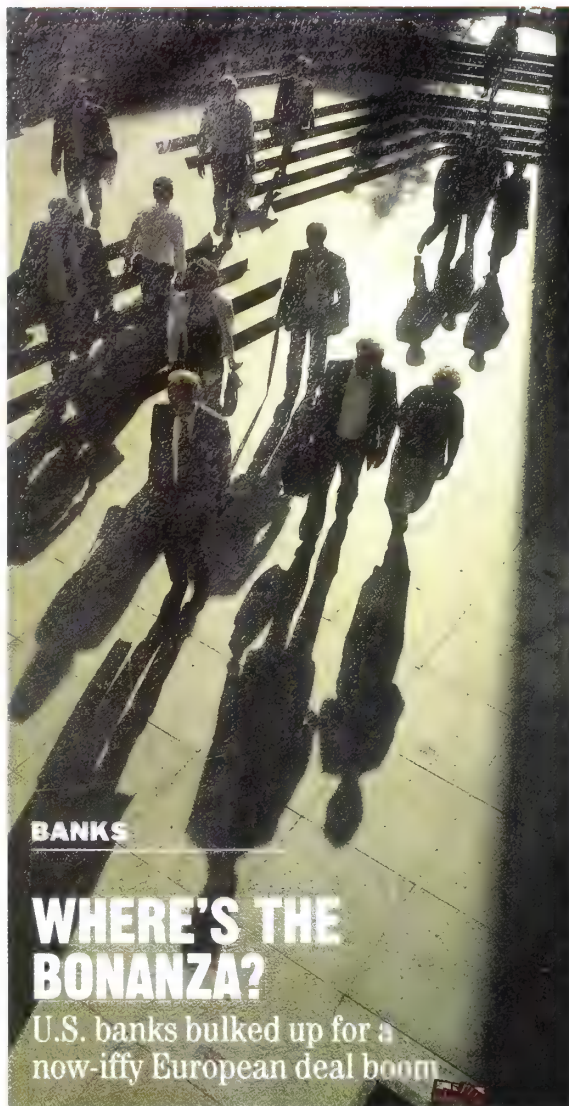
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BANKS

WHERE'S THE BONANZA?

U.S. banks bulked up for a now-iffy European deal boom

September was to be a grand month for MorphoSys, a Munich-based startup that clones human antibodies. Its founders planned to list 25% to 30% of the company on Germany's small-company stock exchange, the Neuer Markt. No longer. "There is too much turbulence in the markets right now," says CEO Simon E. Moroney.

That's not what Europe's investment bankers want to hear. Anticipating a financial-services boom in Europe, U.S. firms such as Merrill Lynch & Co. and Morgan Stanley Dean Witter, and European rivals such as Deutsche Bank, which advises MorphoSys, have poured money into investment banking. With the American securities industry looking increasingly saturated, the Old World was to play a key role in future growth.

But if rocky markets halt the development of Europe's financial system, the banks could be stuck with hefty costs instead of fat profits. Billions of dollars

SUBDUED: Profits in the City will take a hit, but mergers haven't slowed

in trading losses resulting from the collapse of Russia and the ripple effects of that debacle will put a dent in most banks' earnings. "There has been a significant slowdown in the sale of risky instruments, from emerging markets to lower-rated corporate bonds to structured assets," says Bill Winters, head of European fixed income at J.P. Morgan & Co. in London.

Any disappointments in Europe could pose serious problems for American firms. Goldman, Sachs & Co., for instance, has beefed up from just 73 people in Europe in 1980 to its present level of around 2,500. Goldman, which is on the verge of a historic initial public offering of its own, pulled in \$694 million in pretax earnings in Europe in the first half of 1998, one-third of its total. All of Goldman's major U.S. rivals also have expanded aggressively in Europe and are vulnerable to a slump. Merrill Lynch, for instance, has been on a multibillion-dollar buying spree and now has about 8,000 employees in Europe. If market volumes drop, that much overhead could become a heavy burden.

Industry layoffs are undoubtedly in the works. Aside from emerging markets, fixed-income departments, where business has fallen off sharply, could be the hardest hit. But the stronger American firms are convinced that Europe can't turn back on its path of market building, and they are ready to absorb some short-term earnings hits to reap the benefits.

Even strong U.S. firms, however, are being tested by the current bond-market instability. The European junk-bond market, pioneered by U.S. firms over the past 18 months, has stalled. The Americans were making progress in enticing European institutional investors

into taking pieces of riskier debt issue. Now, with prices down 10% to 12% their appetite for risk has dwindled.

Bankers hope that investors will get over their squeamishness and recognize a buying opportunity. But until they do the entire fixed-income area—from emerging markets to high-quality corporates that have been a major source of profits for banks—will be hurting. That could put pressure on firms such as Salomon Smith Barney and Lehman Brothers, which focus largely on bond **BRIGHT SPOT.** So far, mergers and acquisitions remain one of the bright spots in the City of London, Frankfurt, and Paris. August was a strong month for takeovers, with some \$21.5 billion in deals involving European companies—about the same as the previous August according to IFR Securities Data in London. Although the current market turbulence may bring less pricey deals, those lower prices may later lead to increased M&A activity. "Values are emerging in some sectors that haven't been there for some time," says Lazard Brothers Vice-Chairman John Nelson. "Those with cash will move into the market."

Yet an even more important question is whether or not individual investors will do the same. So far, Europeans are continuing to pump money into stock funds, but the flows may be slower. In August, for example, Italian investments in equity funds declined to \$290 million, compared with about \$3.1 billion the month before. Fidelity Investments is noticing some shifting from equities into bonds among its European clients, but inflows into stocks remain positive. So far, investors and bankers are continuing to bet on Europe's financial and corporate restructuring. But the new volatility is beginning to test everyone's tolerance for trouble.

By Stanley Reed in London

THE CHANGING BUSINESS OF EUROPEAN BANKING

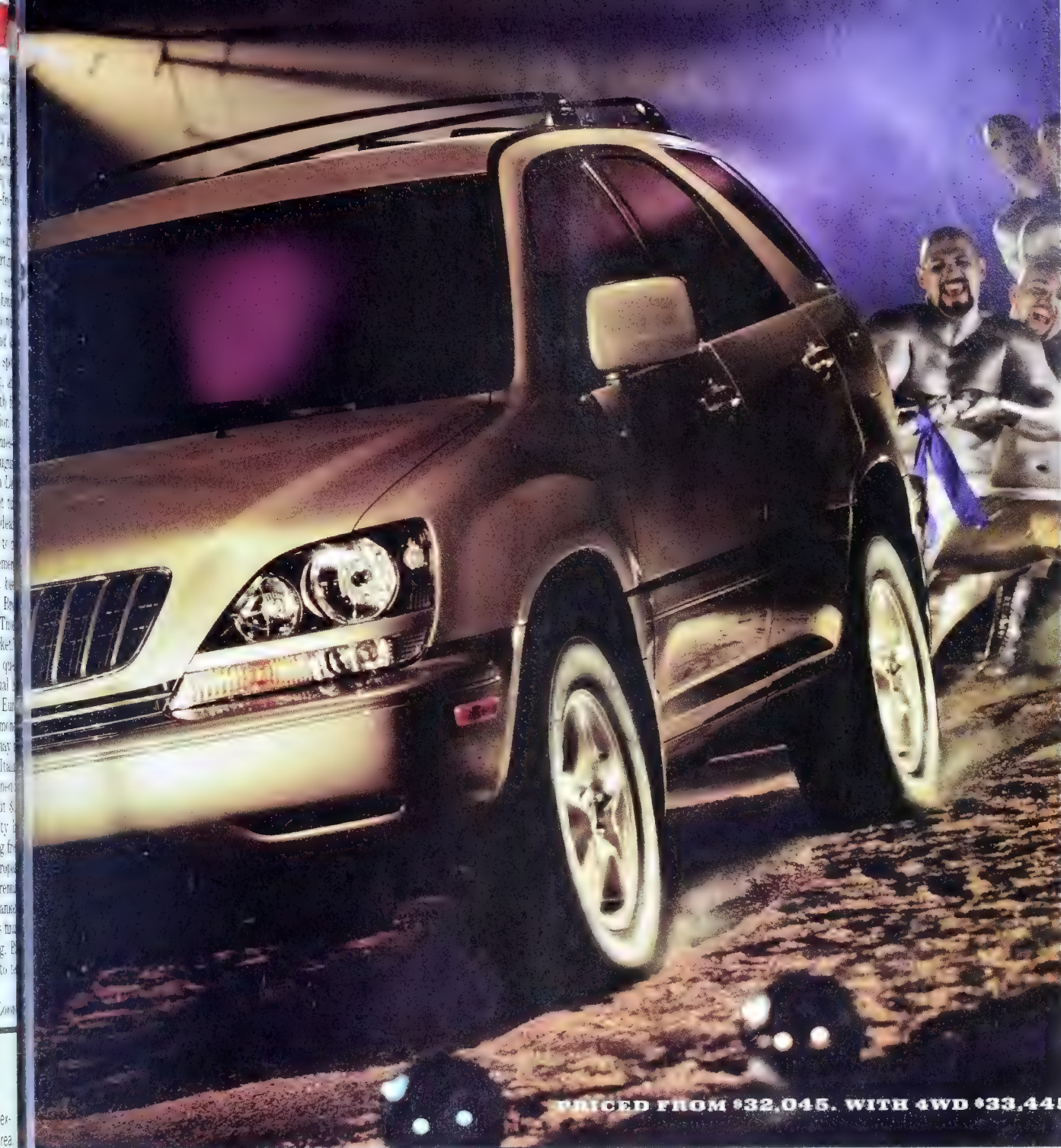
EMERGING MARKETS Companies are reexamining their employment levels in this area.

FIXED INCOME Prices are off as much as 12% in the once-promising market for high-yield securities.

INITIAL PUBLIC OFFERINGS Top-quality deals may move ahead after repricing, but some small offerings are likely to be shelved.

MERGERS AND ACQUISITIONS Nomura International dropped its bid for Thistle Hotels, but other deals are in the works.

DATA: BUSINESS WEEK



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NORTH KOREA PLAYS A SCARY GAME OF CHICKEN

North Korea's needs are great. But it is having to shout loudly to be heard. In fact, their latest tactics, including the recent firing of a missile over Japan, are just about the only way North Korean officials can get the West to pay attention.

North Korea is pressing for diplomatic recognition from Washington, more aid from the West, and hard-currency investments from the rest of the world. But they've found that the best way to get what they want is to step up their security threat to northeast Asia. "It's a very risky game—walking the line between jeopardizing relations with the international community and showing military muscle," says Charles K. Armstrong, a Korea expert at Columbia University's East Asian Institute.

The game could quickly turn into an alarming diplomatic version of chicken. Whether or not Pyongyang's missile simply launched a satellite paying patriotic songs to celebrate Kim Jong Il's Sept. 5 formal installation as head of state, as the North Koreans insist, it did mark a distinct step-up in the country's missile capabilities. And that, say analysts, intensifies proliferation challenges. Iran, for example, has already used older North Korean technology to develop missiles that can hit Saudi Arabia and Israel.

SMALL BEER. North Korea's tactics are rapidly intensifying the Clinton Administration into a corner. The more menacing North Korea becomes, the greater the opposition in Congress—and in Tokyo—to any concessions. The Senate version of the foreign aid bill that was passed on Sept. 2, for instance, bars promised funds to Pyongyang unless inspections establish that both North Korea's nuclear-weapons program and its exports of missile technology have halted. Already, Congress hobbled the Administration by voting just half the funds needed for fuel-oil

deliveries promised to North Korea in a 1994 agreement. "What we've essentially done is moved the goalposts," says Robert A. Manning, director of Asian studies at the Council on Foreign Relations. "There was no conditionality in the 1994 [agreement]."

Indeed, the North Koreans argue that the U.S. has failed to deliver on several other 1994 promises to reduce obstacles to trade, restore diplomatic relations, and build two nuclear reactors. Some of what the North Koreans are seeking is small beer. They want their star 7-foot 9-inch basketball player to be able to play on a U.S. team, for example, and for North Korean hotels to be allowed to accept Visa and MasterCard. Washington has refused—until the North Koreans agree to tension-reducing measures, such as installing a cold-war-style hotline.

All this comes when Kim is trying to consolidate his power as the country sinks into famine and economic collapse. Over the past two years, he has promoted 120 young officers to general. Now, analysts say, he has packed the Cabinet so that 23 of the 34 posts are newly filled with his loyalists. "Kim Jong Il is likely to whip up hatred and alertness against outside forces to divert [attention from] internal difficulties," says Jo Myong Chol, a former North Korean university professor who defected to South Korea in 1994.

The Clinton Administration's strategy so far has been to buy time. But its gamble that North Korea would be completely absorbed by internal problems and that Kim wouldn't be able to maintain his power has failed. Instead of becoming so weak that it would accept Washington's terms, North Korea is rattling its saber so much that events could easily spin out of control.

By Sheri Prasso in New York, with Moon Ihwan in Seoul



DANGER: Missile launch

GLOBAL WRAPUP

FOR SWISS BANKS, A BIG GAP

News that Switzerland's big banks hold dormant accounts belonging to Holocaust victims worth only about \$71 million may rub salt into bankers' wounds. The figure comes from a preliminary audit by a commission headed by former U.S. Federal Reserve Chairman Paul A. Volcker. The problem is that it is far less than the \$1.25 billion "global settlement" that the Swiss banks agreed to pay on Aug. 2 under threat of economic sanctions.

The global settlement is irrevoca-

ble. And while it was intended to cover more than just dormant accounts, the discrepancy between the settlement and the Volcker estimate is expected to inflame public opinion in Switzerland. Many voters believe the country was railroaded by Jewish organizations.

DUMPING ON THE BORDER?

► Environmentalists are up in arms over a U.S. decision to build a low-level nuclear waste dump in the tiny Texas town of Sierra Blanca, just 20 miles from the Mexican border, call-

ing it "ecological racism." Mexico's Foreign Ministry had protested the dump for two years, contending that a 1983 border pact barred projects that threatened the countries' shared ecosystem.

But last week, Mexico's executive branch overrode the Foreign Ministry, saying that Mexico's National Nuclear Safety Commission had concluded the dump was safe. City officials from Ciudad Juárez, across the border from El Paso, Tex., are lobbying to block the dump, as are U.S. branches of the Sierra Club.



The Daddy

Men face greater expectations at home. But work isn't giving them the slack they need

Jeffrey Welch thought he had the work-life thing figured out. Five years ago, newly married, he quit the 14-hour-a-day partner track at an upper-drawer law firm for a staff job at a large New York bank, seduced by the promise of saner hours and time for a family. The family arrived soon enough—a baby, a move to the suburbs, then another child. Time, though, proved a mirage: As his department took on more work without adding attorneys, his job intensified.

Tonight, as has become the norm, Welch won't make it home before his daughters, ages 4 and 1, fall asleep. His wife Carroll, a part-time lawyer, will put them to bed. And tomorrow morning, he'll head to the office again soon after they wake up. "I'd like to participate more in school or camp stuff, but I can't manage my schedule in a way to allow that," he says. "I'm letting go of everything for myself, except for exercise on weekends. And I've given up any attempt to manage our finances."

Welch pauses. He has brooded over this for months now,

with no satisfying answers. Yes, he's making good money, providing nicely for his family. But "I want to be a parent who's involved," he says. "I want to be a dad who, 30 years down the road, my kids say, 'Yeah, he was a big part of our life.' And right now, I'm not that."

If you're a working father, you probably feel Welch's pain. Your own dad, king of his castle, didn't quite prepare you for the rigors of the two-income family. He kicked back with a beer and the paper at day's end, while mom whipped up a meat loaf and you played at a respectful distance. Today, you're on the hook for that dinner and some of the housework, too—but your job seems more demanding than dad's ever was.

Across the country, men are battling just such angst. "Right now, my entire life is work," says

Darrell Shelton, a 42-year-old paint repair specialist at Ford Motor Co.'s assembly plant in Chicago Heights, Ill., who cares for his daughter while his wife works nights. After a 10- or 12-hour shift, "I've got to get Rebecca, get everything straightened out at home, maybe sit down for a minute, get something

Special Report



Trap



o eat, get the baby's plate, then go play with the baby. You just don't ever stop." Says Gary Dunn, an inspector for the Lucas County (Ohio) Sanitary Engineering Dept. and father of three: "I'm trying to serve all these masters—between the kids, my wife, my job, the union, athletics. I'm doing the best I can."

These men—and you, perhaps—are caught in the Daddy Trap. In the last two decades, expectations of men at home have intensified dramatically. Dads are more involved with their families, and in general they enjoy that heightened role. Yet their jobs haven't adjusted. Faced with pressure to take on more child-rearing and household chores, fathers still find themselves locked into rigid full-time jobs.

Some of the tension is workplace-inflicted. A lot is self-imposed. The result, in either case, is conflict, guilt, and stress. It turns out that dads are no more satisfied than moms with their work-family balance, according to a sample of 6,328 working parents derived from BUSINESS WEEK's 1997 survey of corporate work and family programs, conducted with the Center for Work & Family at Boston College. Surprisingly, dads are more likely than moms to say work spills over into home life, the data show—and quicker to complain that employers demand too much at the expense of family (charts, page 58).

It is a phenomenon that only recently has drawn serious scrutiny from employers and human resources researchers. As women have poured into the labor force, many companies have tried to address the urgent needs of working mothers—

James F. Halpin

WEEKEND COMMUTER

AGE 48

FAMILY Wife at home; two kids

JOB Chief executive officer, CompUSA Inc., Dallas

HOW THINGS WORK Five years ago, Halpin moved to Dallas to take charge at CompUSA, the computer superstore chain. His family stayed in the Massachusetts town where they have lived since 1983. Halpin knew the job would be grueling—so he saw no reason to uproot his family when he'd have little time to spend with them. He flies home most weekends. "At times, it hasn't been easy," says his wife, Joanne. But "he is providing us with a wonderful life." And "when he's here, he's here 100%."

HIS TAKE "When you're a high-level executive, your kids are not going to see you that much during the week, living at home or not. If I were working in New England, I'd still be traveling three days a week or working 12-hour days. [But] quantity of time is not necessarily as important as quality of time. When I'm home, I'm Dad."

Men may be willing to try flextime, but they rarely take parental leave—or quit for a few years

particularly, child care and job flexibility. But dads? They mostly have been overlooked. "Even work-life champions don't think about that," says Ellen Bankert, director of the Center for Work & Family.

"UNWITTING COLLUSION." Such neglect, of course, has made a certain sense. Employers have been loath to lose female workers who, faced with work-life conflict, historically have been quicker to seek out new jobs or leave the labor force entirely. Men, true to stereotype, have tended to react more stoically. "The thing I'm always struck by is how much men keep this to themselves," says James A. Levine, director of the Fatherhood Project, a New York research group, and author of "Working Fathers." "There's this unwitting collusion between men and women and employers. No one wants to put this on the table, so the assumption is perpetuated that it's a woman's issue."

Special Report

The silence is lifting, though. Listen to guys talking in health-club locker rooms, at business lunches, or on factory floors. Their conversations turn persistently to fathering and work-life balance. In dozens of interviews with dads across the demographic and occupational spectrum, the tensions sparked by job and fatherhood surface quickly. Men's attitudes and actions, slowly and sometimes painfully, are changing. And employers are starting to notice. "Obviously, there's a need out there" for more support, says Betty K. Purkey, work-life programs manager at Texas Instruments Inc.

Dads' evolution in the workplace follows a revolution at home. In surveys for the Families & Work Institute, a New York research group, married men last year said they spent 2.1 hours per workday on household chores, up from 1.2 hours in 1977. Men also said they spent 2.3 hours per work-day on child care, half an hour more than two decades earlier. In both areas, women reported spending less time.

To which, of course, many women will mutter, "Yeah, right."



Darian Berry

DAY JOB, NIGHT DAD

AGE 27

FAMILY Wife works full-time; two children

JOB Bellman, Excalibur Hotel, Las Vegas

HOW THINGS WORK Berry works 10 a.m. to 6 p.m. Then his wife, Donna, 28, drops the kids, Nikiya and Tyree, at the casino before starting as a waitress at the Luxor Hotel next door. The arrangement goes smoothly, but at a price. When Tyree was born, Berry quit the University of Nevada at Las Vegas, because they couldn't afford day care for two kids. He hopes to return to school at night next year.

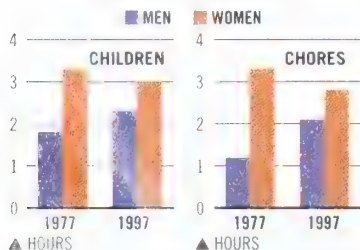
HIS TAKE "I saw my father doing the same types of things. My father was a blackjack dealer. He did the laundry and the shopping. To help out is just a natural thing."

In truth, such data probably overstate men's contribution. Studies by University of Maryland time expert John P. Robinson, based on logs of people's activities, indicate a smaller shift. Moreover, despite the hours they put in, dads' roles are often vague and secondary—either because fathers haven't seized the initiative or because their wives haven't let them. "Our expectations are so low, as mothers, wives, and co-work-

Dad's Dilemma

More Demands At Home...

Hours per day working men and women report spending with children and on household chores



...But No Break From Work...

Percentage of parents employed full-time who say they work 46 hours a week or longer, by occupation

	MEN	WOMEN
PRODUCTION WORKERS	39.9%	12.7%
PROFESSIONAL/TECHNICAL	45.9	21.3
MANAGER/SUPERVISOR	72.9	50.5

DATA: FAMILIES & WORK INSTITUTE, BUSINESS WEEK, CENTER FOR WORK & FAMILY AT BOSTON COLLEGE

The Families & Work Institute survey, consisting of 2,877 telephone interviews—1,068 with married parents, and 58% of those male—was conducted by Louis Harris & Associates in

...And a Tenuous Balance

Percentage of parents in full-time jobs who say their company asks too much at the expense of family (either "somewhat" or "a great deal")

	MEN	WOMEN
PRODUCTION WORKERS	48.2%	37.4%
PROFESSIONAL/TECHNICAL	41.9	37.6
MANAGER/SUPERVISOR	46.2	44.0

July, 1997. BUSINESS WEEK's sample includes 6,328 full-time employees—49% male—with children or dependents living at home, drawn from 11,664 questionnaires returned by employees from 55 companies in July, 1997

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ers, that we give a lot of credit for not much and don't expect more," Bankert argues (page 66).

Whether or not they actually take on responsibility at home, though, dads say they feel growing pressure to do so. And in many households, especially where both parents work, men's expanded involvement has become indispensable. Darrell Shelton, the Ford worker, cleans house and spends Sundays grilling all the family's dinners for the week. Dunn, the sanitary engineering inspector, does laundry and dishes, takes his kids to doctors appointments, and makes every parent-teacher conference. "I put everything second to the kids," he says.

Special Report

That's a common, usually heartfelt refrain. The reality, though, is more complex. While men say they attach as much importance as women to their families, they haven't compromised their careers as often. Dads in full-time jobs work between three and five hours a week longer than full-time working moms in comparable occupations. And while, in many companies, men are just as likely as women to arrange for flextime or telecommuting, they're far less willing to seek part-time work, quit the workforce for a few years, or even take a few weeks' paternity leave—more radical options that require giving up pay.

In purely economic terms, this is easily explained. On average, guys still make 35% more than their wives, so cutting back on work makes less financial sense. Many researchers, too, say workplace cultures demand more of men than women. While supervisors mostly understand that their female employees play key family roles, Levine argues, men are more likely to be drafted for overtime or an extra meeting.

There's more to it, though. If dads felt strongly enough, they could challenge such cultural biases. Yet men still tend to feel a stronger attachment than women to their jobs. Women, on the other hand, generally feel more passionately about their children, and so "are more likely to pull back on careers," observes New York University sociologist Kathleen Gerson.

Eric Weisler

"NO BALANCE"

AGE 35

FAMILY Wife at home; three children

JOB Online producer, barnesandnoble.com, New York

HOW THINGS WORK When his son, Alexander, was born nine years ago, Weisler was working nights, first at British Airways, then at a law firm. By day, while his wife, Bonnie, worked as a nurse, he was a parent. He found it rewarding but frustrating: It was hard to make male friends. More difficult was the adjustment to his current full-time day job—and to ceding most parenting to his wife. He's still involved at night and on weekends and helps with Alexander's Cub Scout pack. But he finds his new role as "secondary" parent "less natural and more calculating."

HIS TAKE "There's no balance—the needs of a man vs. the responsibilities of a family man. Last night, I got home at 7 p.m., and it wasn't until 9:30 that all the kids were in bed. Now, I have to fulfill my role as husband and catch up on my wife's day. By the time we're done, it's after 10 p.m. I wanted to see the Mets game, and that's gone."

That gap in attitudes is startlingly pervasive. In the Families & Work Institute survey, half of both working fathers and working mothers agreed with the statement: "It is much better for everyone involved if the man earns the money and the woman takes care of the home and children." The old breadwinner ethic, in fact, still guides men's behavior; even in the 13% of households where the wives make more. It may be archaic, but "it has been ingrained in us for so many generations," says Graeme D. Roberts, a father of three and a mar-

**Who does
Berkshire
Hathaway
ask for
an outside
opinion?**

t h e a n s w e r i s

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keting executive at Gradient Lens Corp. in Rochester, N.Y. "You can decree that, but if I didn't feel I could provide, I would think less of myself. I think a lot of men feel that way."

Such men tend to justify long hours and stressful work as a means to a greater end. V.D. Sterling works six days a week as a train engineer for Union Pacific Corp., often responding to a dispatcher's call within

Special Report

minutes and then overnighting in motels. He keeps going because he loves the work and because he can make up to \$100,000 a year. "I put it like this," he says, watching his 2-year-old daughter on a rare day at home. "I've taken my family on a cruise every year since I've been working, sometimes twice. We've been to Europe. If you're looking for a nine-to-five job where you're going to be with your family, you've come to the wrong place with the railroad. But I think it's worth it."

HEAD GAMES. Such stolid machismo, reinforced by workplace norms, prevents many fathers from striking the work-family balance they say they want. That's especially true among production and clerical workers, who complain of longer days and far less flexibility than do female peers. Why? Even though blue-collar employees tend to be less career-driven, experts suggest, their work environments are characterized by more traditional views of gender roles.

And men in such jobs are less likely to voice any objections.

Jimmy Gellentine, a 31-year-old loading-dock worker at Overnite Transportation Co. in Memphis, struggled to juggle his evening job with the care of his daughter. His wife, Denise, wanted him to move to a day shift, but "I didn't even bother to ask, because I didn't want to be seen [by co-workers] as kissing up to management" by seeking special treatment, he says. Gellentine recently won the job by virtue of seniority—as he wanted—but four years after the fact.

Similar, but more subtle, head games play out in the managerial ranks. Craig G. Byquist, 35, is a manufacturing engineering manag-

In turning down a promotion, one executive realized, "I'm going to be a father longer than I'll be a working man."

er for Hewlett-Packard Co. in Lake Stevens, Wash. He limits his hours to fewer than 10 a day so he can get home in time to help with dinner and tuck his kids, Nathaniel and Sarah, into bed. His job, like many at HP, is fairly flexible. It's no problem if he shows up late at the office when a child is ill. And he missed the company picnic for Nathaniel's fifth birthday party.

Even so, Byquist says, "there's a self-imposed pressure, when you get into an environment like HP's and you're surrounded by overachievers. You want to be successful, and you want the company to be successful." Given that, no man wants to be the first to blink. HP allows employees to take up to a year of unpaid leave after the birth of children or other personal events, but "I didn't take it, and I don't know any [other men] who did," Byquist says. HP's manager of work-life

Vincent P. Aubrun

BREADWINNER, FOR NOW

AGE 41

FAMILY Wife at home; three children

JOB Technology director, Summit Systems Inc., New York

HOW THINGS WORK Aubrun and his wife, Patricia Godoy, consider themselves progressive on family issues. Yet they admit their marriage has turned traditional. They share cooking and shopping, and Aubrun leaves his job at a software maker in time to spend two hours with the kids. But when Godoy, 38, worked at White & Case, a law firm, he called every afternoon to see if she'd be home to make dinner. And in March, it was Godoy who took a one-year leave when three children and two jobs proved too stressful. "It never entered my mind that Vincent would stop work," she says.

HIS TAKE "I didn't consider not working. I don't think I could spend more time at home. And I feel the responsibility to provide. Society pressures me to be involved with my kids. It would be [less stressful] if that didn't apply."



programs, Jerry Cashman, says such "fear of compromise" is rife among men age 35 to 52, who are defining their careers.

Some employers have started to address the tangle of male emotion, tradition, and frustration—recognizing that fathers have somewhat different needs and attitudes than moms. HP saw that far fewer men than women were using a telephone-based resource service that helps employees with dependent care and other problems. In focus groups, it found that men didn't like the idea of engaging in conversation about such matters; they simply wanted information. Now, HP is testing an Internet-based supplement to the service.

Marriott International Inc., similarly, is rolling out a series of seminars on fatherhood geared specifically to its hourly male ho-

BusinessWeek **ONLINE**

For more profiles of working fathers and a survey comparing men's and women's work-and-family concerns, go to www.businessweek.com



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tel workers. "We have tons and tons of programs that address work-life balance," says Vice-President Donna Klein. "But we designed this program to be specifically because fathers aren't coming to the parent training." Indeed, companies that have sponsored Levine's "DaddyStress" seminars, lunchtime programs that explore fatherhood issues, report unusually heavy attendance. At

Special Report

Theta Instruments, a session last year was oversubscribed 24 hours after it was advertised by E-mail.

Such companies are exploring father-specific initiatives because they realize that men, too, can become more productive workers if their families needs are better fulfilled. Some dads, however, will just stay unhappy enough. In fact, more men appear to be opting out of the labor force altogether to stay with their children full-time. Eilan Krueger, 41, took over the care of his 2-year-old daughter, Malena, when his wife, Karin, won a high-paying job as a Washington lobbyist for the Motion Picture Association of America. Together, father and daughter explore the parks and pools around Bethesda, Md., where they live; dad does the laundry and cooks dinner every night.

"A BIT SCARY." Sure, he suffers self-doubt. Krueger remembers when he used to consider job applications as manager of a mountaineering store; then, he viewed with suspicion a five-year gap in a man's résumé. "That's a little bit scary," he says, and it's why he's scouting out real estate deals on the side. Even if business arrives, though, he expects to keep working part-time from home. "My dad worked like crazy until I was 10," he says. "I wanted to be there from the beginning."

Krueger represents a tiny minority, of course. But there's evidence that more men are finding paths out of their traditional, career-driven molds. At companies such as NationsBank and IBM's Lotus Development, the number of men taking paid paternity leave has edged up in recent years. And Spencer Stuart, the executive recruiting firm, notes that more top-level male executives are refusing jobs that involve relocation. Bruce L. Entin, marketing vice-president at chipmaker LSI Logic Corp., turned down a promotion to head LSI's European operations five years ago so his three school-age kids could stay in California. That difficult decision, he says, "was where I came up with the philosophy that I'm going to be a father longer than I'll be a working man."

More working dads, too, are devising informal, cooperative

solutions to ease the work-family strains. At the Ford plant in Chicago Heights, Kevin Pinckney and other production supervisors, many of them dads, share the load when one or another has to leave for a family emergency. Similarly, William L. Robinson and Tony Sinurdiak, maintenance engineers for the Illinois State Toll Highway Authority, cover for each other two or three times a month—notably, when Robinson's son, Jay, then 5, injured his eye at school four years ago.

FITFUL CHANGE. A younger generation of dads probably will push well beyond such solutions. The Families & Work Institute found that Generation X men—those age 18 to 32—were far less likely to endorse the traditional breadwinner ethic than those of comparable ages 20 years ago. New York University's Gerson has found similar generational shifts in inter-

views with dozens of young men. A sign of blue-collar progress: Unions such as the United Auto Workers are raising work-family issues in contract talks.

The change, certainly, will come fitfully. Cultural barriers in the workplace remain powerful, as do dads' own conflicting instincts. "For men there's still this sense of 'What am I giving up?' They agonize much more over it," says Chuck Seiloff, a high-ranking Hewlett-Packard information systems manager who, at age 54, took a demotion and pay cut to devote more time to his grandchildren and other personal interests. Fathers may feel torn because the increasing openness of employers to flexible work options and shorter hours forces them to confront their internal breadwinner mind-set. "Having an easier choice makes them more accountable," as Seiloff observes.

Indeed, older men such as Arthur Brown Jr., an army general now retired in Hilton Head Island, S.C., say they never thought much about their career-centered roles and marvel at the multiple demands facing fathers today. "They have to be under tremendous stress," Brown says.

"How they're handling it all must be incredible."

Brown and many of his generation largely applaud such change. Their sons' lives may be unfamiliar and complex, but they seem more rewarding, too. In grappling with old gender roles at work and at home, in confronting the conflict, guilt, and stress, men are beginning to consider anew what fathers should be. As they do, more will redefine their work-life balance—and, perhaps, escape the Daddy Trap.

By Keith H. Hammonds in New York, with Ann Therese Palmer in Chicago and bureau reports



Cesar Gomez

WORLDS APART

AGE 34

FAMILY Wife works full-time; one young child

JOB Flight attendant for Northwest Airlines Inc., Los Angeles

HOW THINGS WORK Life "is very confusing," admits Gomez, whose wife, Gloria, also is a Northwest attendant. The two stagger schedules to care for Alexandra, 18 months. Cesar cooks and vacuums. The hitch: He and Gloria rarely see each other. Four or five times a month, too, one lays over, and the other must drive Alexandra an hour to Gloria's mother. He'd prefer Gloria not to work, but they need both incomes to cover the mortgage and other expenses.

HIS TAKE "Yesterday, Gloria left for Osaka. Today, I came from Tokyo. We met for 20 minutes at the airport. Northwest does nothing to help. [Once,] Alexandra was sick, and my wife called in sick. The supervisor said that if she was going to call in sick a lot, she should quit." [Northwest says its policies are "very, very lenient."]

**This assignment started
in a flea market and ended
in a national shrine.**

This class boat trip to Ellis Island actually began at a flea market in Rhode Island, where ninth-grade teacher Maureen Whalen Spaight bought a package of old immigrant photographs for \$3.00. Later, she had each of her students pick one of the photos and develop a character based on it.

Her students then completely immersed themselves in the immigrant experience by creating journals for each of their immigrant characters. These journals recorded the characters' reasons for immigrating, their doubts, their dreams and the difficulties they and their companions faced as they began life in their adopted country.

For showing her students that a picture truly is worth a thousand words, State Farm is proud to present Maureen Spaight of E. R. Martin, Jr. High School of East Providence, Rhode Island with our Good Neighbor Award and to donate \$5,000 to the educational institution of her choice.



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By Kelley Holland

MEN: 'COMING AROUND, BUT THEY'VE GOT A LONG WAY TO GO'

It's 5 a.m., and I can't sleep. This is my fourth fitful night in a row, and I know what the problem is: My son's nanny is taking two weeks off for a family emergency, and for the past three workdays, Henry has been ensconced in a backup day-care center. It's a perfectly pleasant place, and he may well be having a good time once he settles in. But he sobs when I leave him there each morning, and I worry that he'll never adjust to

preschool and that I'm scarring my 2-year-old for life.

Special Report

My husband would sympathize, and he'd help devise another arrangement if I asked. But I don't. And Steve is sleeping soundly. He loves Henry as much as I do, but he doesn't get worked up over these small crises. "You worry about these things more than I do, and more than you need to," he says.

Catching up with other mothers over coffees or in phone chats, I find such differences are typical. In most two-income families, dads are taking on more housework and day-to-day child care than their fathers did. My pediatrician husband is far more involved than most. But when it comes to the more strategic, emotionally laden aspects of child-rearing—researching schools, finding age-appropriate activities, or contending with the fallout from a child-care breakdown—it's still usually Mom who is on the spot.

"Men are coming around... but they've got a long way to go," says Lenard W. Kaye, a professor of social work and social research at Bryn Mawr College. "What they do and what they're best at are the concrete dimensions of child care: transportation, finances," he says. They are "less inclined to invest themselves in the more emotionally and socially intimate as-

pects of family life." The distinction is well reflected in children's behavior. A study released in May by the Whirlpool Foundation found kids much more likely to go to their mothers to share good news, seek advice, or find consolation.

hand off. But my responsibilities, while often rewarding, can also provoke more anxiety. I manage all of Henry's child care, from his nanny to backup day care to the sitters we use on occasional nights out. I also see to his health needs, in part because my doctor husband and I agreed that I had to feel comfortable with Henry's physicians myself. If Henry gets sick, I'm usually on call. I scout out the play groups and toddler classes, and I stay home with Henry every morning until the nanny comes.

OVERANXIOUS? Steve says he takes on the chores he does partly because he thinks I have a more acute need to be with my son when I'm not working, and he wants to free me up. "I see my role as trying to help you balance the work-and-mom conundrum," he says. "I try and do things that will allow you to have more time with Henry." It's a wonderful approach. But it still leaves me with lots to do. As Henry's second birthday neared, I bought party invitations, rounded up toddler pals, and found a playground for

HEAD CHEF: *Holland's husband does most of the cooking*



Fathers tend to be less emotionally invested. A new study finds kids far more apt to go to Mom to share good news or for advice and consolation

In our family, we share a lot. My husband and I divide Henry's baths and feeding. And we both run errands and make forays to the local market. But Steve does the major grocery shopping because he drives to work and can stop on his way home. As the more enthusiastic and skilled chef, he does most of our cooking. And he is always home by 7 p.m. on the two nights each week when I work late.

That's plenty—and Steve's tasks are ones I'm happy to

our little celebration. Steve admits that, left to his own devices, he would have bought a cake, called our immediate families, and been done with it. "I'm not a party planner," he says, "and I don't think Henry would

miss it at this age." He might be right: It's possible I like Henry's parties even more than Henry does. But you never know.

I may well be overanxious. And truth be told, I really don't want to give away my responsibilities. Plenty of other women feel the same way. Says Patricia Godoy, a mother of three on a leave of absence from her job as an attorney: "Not only am I the parent of last resort, I don't think I would want it to be otherwise." But there are plenty of nurturing opportunities to go around. We'd be happy to share, especially at 5 a.m.

Holland is an associate editor for news coverage.



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PUBLIC HEALTH

A FRESH SHOT AT MALARIA?

New research may spur drugmakers to action

Dr. Stephen L. Hoffman is determined to conquer malaria, a scourge many public-health experts call the world's most grievous disease. How determined? On a spring day in 1987, following in the tradition of scientists who put their own health on the line, the Naval Medical Research Institute captain pressed an open carton with five malaria-laden mosquitoes against his arm and waited until they feasted on his blood, infecting him with the parasite. For two weeks, it appeared that an experimental vaccine had protected him from the disease. But then, while giving a presentation at a San Diego conference, Hoffman began to shiver with the uncontrollable shaking chills of malaria. "Unfortunately," he says, "the vaccine failed."

Now, Hoffman is scrambling to get funding for an innovative idea dubbed MustDo (for multi-stage DNA vaccine operation). In papers submitted for publication, he and his colleagues describe promising new vaccine results and report, for the first time, the complete DNA sequence of a malaria chromosome. It's all part of an explosion of new science that could revolutionize "not just malaria vaccine development but the way the biomedical research is done," he enthuses.

Standing in Hoffman's way, however, is the daunting scientific task—along with the West's longstanding apathy toward malaria. The disease's toll is staggering. The parasite slays an estimated 2.7 million people a year worldwide—nearly all in developing countries—and infects some 500 million. Yet spending for malaria re-

search and control totals about \$100 million—a pittance compared with, say, the \$2.5 billion the National Institutes of Health spend on cancer research.

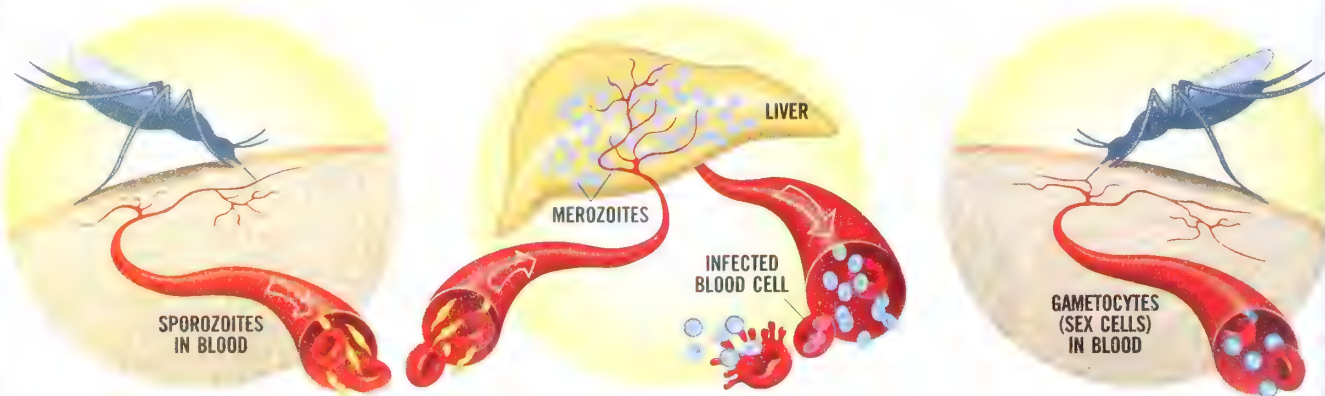
What's more, the pharmaceutical industry's pipeline is nearly empty of new drugs and vaccines. Mosquito-control efforts are also faltering, and malaria is developing resistance to drugs, meaning they won't be effective much longer.

Now, however, officials are getting more serious about tackling malaria. In May, Gro Harlem Brundtland, the new director-general of the World Health Organization, launched a \$20 million plan for cutting deaths in half by 2010. Meanwhile, WHO and industry representatives and others will meet at New York's Rockefeller Foundation on Sept. 17 to consider a plan for foundations and health agencies to fund academic-industry partnerships to develop new drugs.

COMPLEX CYCLE. The growing will to fight the disease couldn't come at a more opportune time. "Malaria has come back with a vengeance," says infectious-disease specialist Philip K. Russell of Johns Hopkins University School of Public Health. Cases have soared across Africa and Asia. Malaria was the top cause of casualties among U.S. troops in Somalia, despite the military's extensive use of malaria medications. And it has recently struck Americans

FOILING A DEVIOUS INVADER

With only meager support, scientists and international agencies are struggling to tame a parasite that kills 2.7 million people a year—and is spreading. But there are some promising new approaches. Here's a look:



1 An infected mosquito bites, sending into the bloodstream a form of the parasite known as a sporozoite.

STRATEGIES Draining swamps, stocking ponds with fish that eat mosquito larvae, and using insecticide-impregnated bed nets can cut the rates of infection.

2 Sporozoites rush to the liver, where they infect cells, multiply, and turn into another form, called merozoites.

STRATEGIES A vaccine based on proteins produced by the sporozoite may prod the immune system enough to kill infected liver cells and sporozoites.

3 Merozoites burst out of the liver and invade and kill red blood cells, causing fevers and anemia.

STRATEGIES Some strains of malaria can sidestep the existing drugs or actually pump them out. So scientists are developing new drugs that block the pump or attack new targets.

4 Some merozoites turn into gametocytes, or sex cells, which are sucked up by another mosquito, beginning the cycle anew.

STRATEGIES Stimulate the immune system to make antibodies that will be sucked up by the mosquito. They may be able to halt the deadly cycle of infection.

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Science & Technology

in New York and Tidewater Virginia.

The ideal solution would be a vaccine that prods the immune system to wipe out the parasite. It's a difficult task, partly because the life cycle of the malaria parasite is so complex. The dance of parasite and host begins when an infected mosquito injects a few dozen pointy malaria cells, called sporozoites, into the blood (diagram, page 70). The sporozoites rush to the liver and multiply like mad. By the time the immune system mounts a response, sporozoites in the liver have changed into a new, rounder form called a merozoite. Bursting out of liver cells, the merozoites infect and destroy red blood cells, causing fever, chills, and anemia. Some of these merozoites then become gametocytes—sex cells—which, after being sucked back into another mosquito, eventually give rise to sporozoites that begin the cycle all over again.

Back in 1987, Hoffman and other researchers hoped that a vaccine based on a key sporozoite protein would prod the body to make antibodies against the sporozoite, thus wiping out the parasite. The vaccine's failure taught them that fighting the parasite with antibodies alone is like trying to stop an elephant with a handgun: The antibodies need

help from the other part of the immune system—so-called cellular immunity. Hoffman and others have been working with vaccines made of DNA strands that when injected into muscle, help generate an immune response involving killer T-cells. In his forthcoming scientific paper, he and colleagues will report that such a vaccine is safe and does stimulate a T-cell response in humans. Even with that improvement, however, scientists predict that no sporozoite-based vaccine will ever be better than 85% to 90% protective. That's woefully inadequate for Africa and other places where malaria-carrying mosquito bites occur many times a day.

STRUGGLING. In another approach, Louis H. Miller and colleagues at the NIH are fashioning a vaccine using proteins made during the parasite's blood stage. Such a vaccine can't prevent the disease but could lessen its severity. And by including both sporozoite and blood-stage proteins, Hoffman's MustDo vaccine promises to reduce infection rates and to temper any disease that does appear. "I'd like to think that in my career we will develop an effective vaccine," he says. Until that happens, drugs, used for treatment and preven-



tion, are the best way to tame malaria.

With companies having shut down most of their malaria efforts, military and academic labs struggle to fill the void. At the Walter Reed Army Institute of Research, Colonel Wilbur M. Hous heads a team that has devised a new drug now in human trials in Africa and Thailand. "It may be the most significant thing that's happened at this i-



The strength of any element is not in its might but in its



TESTING IN INDIA:
*Malaria infects
500 million people
a year worldwide*

drugs. That way, "we can regain the use of chloroquine," she says.

Malaria research is also about to get a boost from the deciphering of the parasite's DNA. J. Craig Venter, head of The Institute for Genomic Research (TIGR), will soon publish, with Hoffman and his colleagues, the first sequence of one of malaria's 14 chromosomes. It contains more than 200 genes. And the genes code for proteins that contain numerous repeats of the same building blocks, or amino acids—a pattern seen in no other species. Having the full genome will not only offer many more targets for drugs or vaccine possibilities, researchers say, it will also catapult malaria from a backwater area of science to center stage.

But all of this progress will amount to nothing unless industry steps in to carry drug and vaccine candidates from labs to pharmacies. And with a few exceptions, such as SmithKline Beecham PLC's collaborations with Walter Reed, companies aren't willing to spend the bucks.

That's why scientists are desperately seeking strategies to solicit more industry involvement. At a recent meeting of

drug CEOs, NIH chief and Nobel laureate Harold E. Varmus challenged them to set aside profits from blockbuster drugs to tackle diseases such as malaria. At Harvard, Wirth is setting up a consortium to get public-sector and industry donations. And Dr. Alain B. Schreiber, CEO of biotech company Vical, which holds key patents on DNA vaccine technology, surprised his staff by agreeing to supply Hoffman with enough of his MustDo DNA vaccine for clinical trials. "Malaria is a wonderful setting to test the technology," explains Schreiber.

The most ambitious effort, however, is being led by Trevor M. Jones, director general of the Association of the British Pharmaceutical Industry, and Winston E. Gutteridge of the WHO. They've devised a plan for companies to collaborate with academic labs on projects funded with \$15 million to \$30 million a year from foundations and agencies. "I've felt a sense of despair as to whether we could find the right mechanism," says Jones. "But I now feel this will lead to actual drug hunting." If the cash does materialize at the Sept. 17 meeting, then there's a glimmer of hope that malaria can finally be conquered.

By John Carey in Washington

stitute in 20 years," Milhous says. At Johns Hopkins, chemist Gary H. Poser has a drug that cures animals. Unfortunately, he can't find a drug company willing to take on its development. And at Harvard University's School of Medicine, tropical medicine specialist Dyann F. Wirth is searching for chemicals that can block a key mechanism the parasite uses to elude chloroquine and other

consistency.



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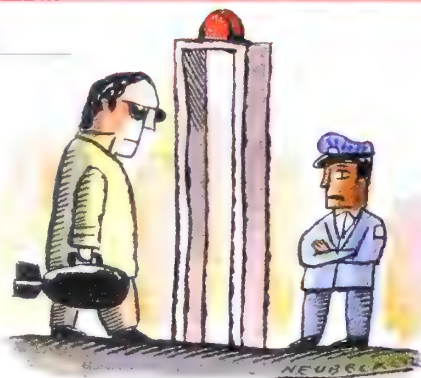
MAKING SEX SAFE FROM DISEASE

AMERICA IS IN THE MIDST OF an epidemic of sexually transmitted diseases (STDs). Gonorrhea, syphilis, chlamydia, and other bugs strike some 10 to 12 million people each year. One in five adults now has herpes, for instance. And a new study in the Sept. 10 issue of the *New England Journal of Medicine* shows that fully 9.2% of 13,204 female U.S. Army recruits tested were infected with chlamydia, a disease that can lead to infertility.

The frontline defense against STDs is the condom. But studies show that condoms are only about two-thirds successful in preventing disease transmission—and rates of use in the general population never exceed 50%. As an alternative, a number of companies are developing antimicrobial salves that women can smear in the vagina before sex that would kill any bacteria or viruses that their partners may harbor.

Furthest along, microbe experts say, is Emphyrean Bioscience Inc. in Phoenix. The company is testing a gel containing two substances, otxynol-9 and benzylium chloride, which can block everything from HIV and herpes to chlamydia and syphilis by disrupting cell membranes. It acts like a soap, attacking the organisms without affecting human cells. So far, studies in women show that the product can be used with little irritation.

Full-scale National Institutes of Health-run phase-III clinical trials are scheduled to begin this fall. They will involve Duke University students and other women from both North Carolina and South Carolina. *John Carey*



NOW, IT'S MUTUALLY ASSURED SURVIVAL

RED LIGHTS FLASHED AND bells clanged when U.S. Energy Secretary Bill Richardson carried a briefcase into a new checkpoint at Moscow's Sheremetyevo-1 Airport on Sept. 2—and that's bad news for terrorists. Richardson was testing a system designed to prevent bomb-grade materials from being smuggled out of Russia.

The briefcase contained only radioactive cesium-137, used in medicine. But pirated plutonium and uranium from Russia have turned up in Europe on a handful of occasions since 1991. To clamp down on illegal nuclear traffic, the U.S. will spend \$6 million to

help the cash-strapped Russian government install 16 radiation checkpoints in Moscow's two airports and link all the monitors to a central alarm system. Aspect Scientific

& Industrial Center in Dubna, Russia, builds the monitors, and Los Alamos National Laboratory helped design the alarm system, slated to be operational next year.

Securing Moscow's airports is just for openers. The Energy Dept.'s labs are working with Russia's customs agency to lock up other gateways. Lawrence Livermore National Laboratory, for example, is overseeing the installation of nuclear detectors on the docks at Caspian Sea ports, opposite Iran. Then there's the work Energy is doing to help block the theft of nuclear materials from military facilities and weapons labs. Energy expects to cough up close to \$1 billion to halt nuclear smuggling by 2002. *Otis Port*

TAKE MY FAT—PLEASE

ABOUT FIVE YEARS AGO, HARVARD UNIVERSITY CHEMIST George Whitesides had a brainstorm. Because polymers can be constructed with chemical arms able to selectively grab onto other molecules, why not design an indigestible version that can rid the stomach of unwanted substances? Like fat, for instance.

The idea spawned GelTex Pharmaceuticals Inc. in Waltham, Mass., which by yearend hopes to win Food & Drug Administration approval for its first product: a polymer that grabs onto phosphate in the gut, then is excreted. That's vital for patients whose kidneys can no longer remove phosphate from the blood.

Next in the pipeline is a polymer that grabs onto cholesterol-raising bile acids in the stomach. In current clinical trials, small amounts of the polymer have caused cholesterol levels to drop by 20%, says GelTex President and CEO Mark Skaletsky. Now, GelTex is developing a polymer that can latch onto fat. It wouldn't be ready for several years, but if GelTex succeeds, it may be possible to have your cake and skip the fat, too. *John Carey*

INNOVATIONS

■ Researchers at the San Diego Supercomputer Center have used a Cray T3E supercomputer to compile a massive database for comparing the structures of some 8,000 proteins. The project has already turned up a surprising resemblance between snake toxin and a harmless bacterial enzyme. Such similarities may point the way to improved industrial enzymes or help uncover potential new drugs. Sifting through the database for such clues would take years to decades on most computers, but the Cray can spit out comparisons in only a few weeks.

■ Evidence is mounting that deadly bacteria and viruses carried by tourists and scientists are killing off Antarctica's wildlife. At a late-August meeting in Hobart, Tasmania, some 50 Antarctic scientists called for an international agreement on measures to keep the continent free of the dangerous microbes. In the past few years, scientists have found a virus common to chickens in penguins; salmonella and campylobacter bacteria in the feces of seals, penguins, albatrosses, and skua birds; and a deadly outbreak of salmonella last year that killed 19 skua. Proposals on preventing the spread of disease will be presented to a meeting of the Antarctic Treaty nations in Lima, Peru, next May.



FOR FURTHER INFORMATION: Go to Business Week Online at America Online or E-mail dtwsep@businessweek.com

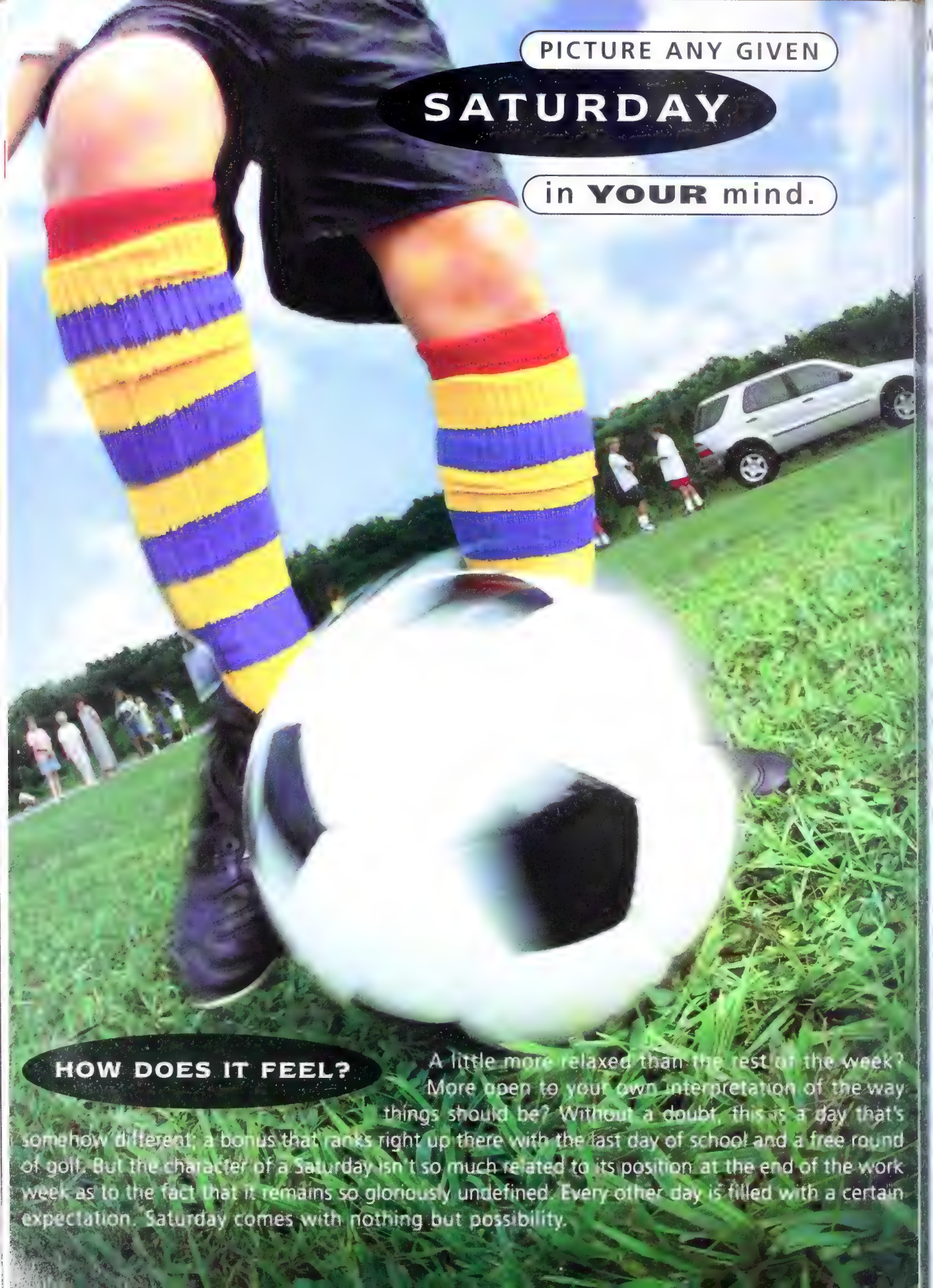


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ON

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?



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SATURDAY

in **YOUR** mind.

HOW DOES IT FEEL?

A little more relaxed than the rest of the week? More open to your own interpretation of the way things should be? Without a doubt, this is a day that's somehow different; a bonus that ranks right up there with the last day of school and a free round of golf. But the character of a Saturday isn't so much related to its position at the end of the work week as to the fact that it remains so gloriously undefined. Every other day is filled with a certain expectation. Saturday comes with nothing but possibility.

WE'RE PROUD TO SAY

you'll find more than a few similarities between the average Saturday and the average day in

ALABAMA.

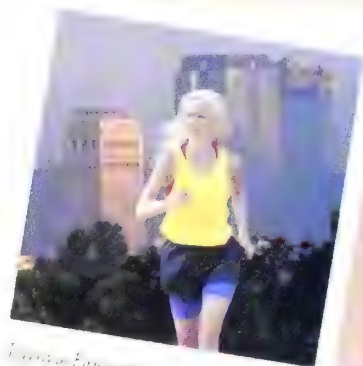
People here are a little friendlier, traffic is a little lighter, the seasons a little warmer. And much like a Saturday, this state operates from a slightly different set of priorities, making conditions perfect for just about anything. Case in point: Mercedes-Benz chose Alabama as the place it would produce its new M-Class All Activity Vehicle because our state fit critical site selection parameters perfectly. Alabama offered an ideal pro-business environment, a solid infrastructure, proximity to major universities, even workforce recruitment and training. But the newcomers quickly realized there was something more to this state. There was a distinctive attitude toward living that would prove to be an important advantage to the new operation. Alabama is a naturally beautiful state where people still believe in family, honest work and loyalty. Those values have translated to an enviable way of life and a refreshing change for a lot of people who now call Alabama home. We'd like you to see things from their point of view.



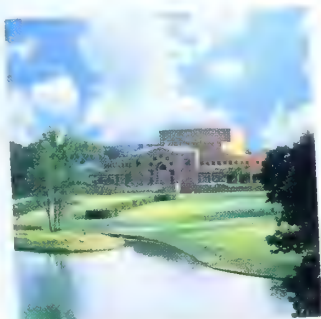
Robert Trent Jones golf train with 314 holes is the largest water port system in the world.



Overnight Museum of Transportation features world's largest collection of the movement for a century.



University of Alabama is the largest university in the world.



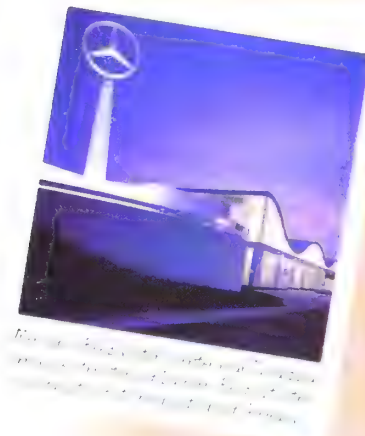
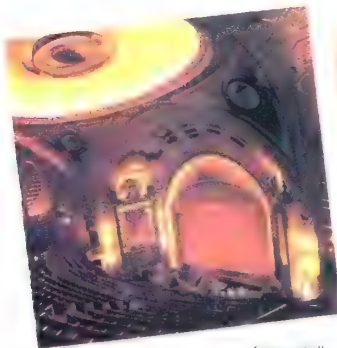
The Shakespeare Theater in Montgomery is the only American theater invited to fly the flag of England's Royal Shakespeare Company.



Pivershale Galleria, Birmingham's shopping city under glass, featuring the world's largest 'volant'.



The Alabama Marching Band celebration, started in 1911.



WORKING together.

Playing **TOGETHER.**



• **Rehau Industries**, a German polymer manufacturer, supplies front and rear bumper systems, as well as other parts for the new Mercedes M-Class vehicle. Many of the vehicle components shipped to Mercedes from its 386,000 square foot plant in Cullman, Alabama arrive fully assembled.

• Complete seat and overhead systems for the Mercedes M-Class vehicle are produced and supplied by **Johnson Controls**, which recently began operation of a new 60,000 square foot facility in Cottondale, Alabama. Like all Mercedes suppliers, Johnson Controls utilizes a "just in time, just in sequence" production method.



• German manufacturer **ZF Industries** produces complete front and rear axle systems for the M-Class. Its new \$20 million Tuscaloosa, Alabama facility now employs about 200 people largely recruited and trained by Alabama Industrial Development Training (AIDT).

As Mercedes-Benz U.S. International began making plans for start-up, the German automaker's first-tier parts suppliers scrambled to begin operations of their own in the Southeast. Most were unprepared for the high quality of the workforce and the sheer amount of cooperation they found in Alabama. Perhaps most impressive was the effectiveness of Alabama Industrial Development Training (AIDT), the state program that works with industries starting up or expanding within Alabama to provide recruitment and employee training. Johnson Controls' Howard Whisenant talks about the Alabama workers hired through AIDT: "They've done an excellent job. We are very pleased with the people we've hired and the job they're doing as we've worked toward the goal of getting our plant up to full speed to begin supplying Mercedes. The work ethic is very good." Another thing the freshly transplanted residents didn't expect? Their new Southern locale turned out to be one of the most inviting places to live and play many of them had ever seen.

Rehau Industries' Sung Yang offers this:

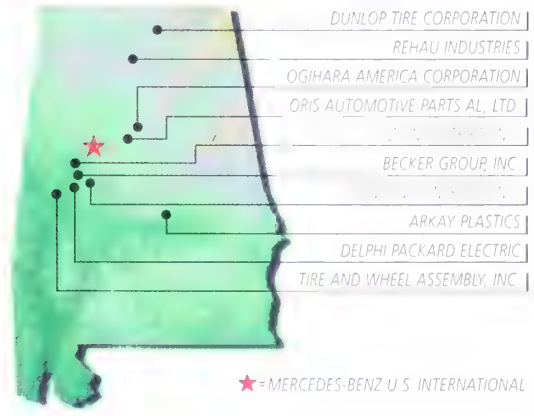
"The highways are full of trees! Every time you get on a highway, it looks like you're going on vacation..."

I've started playing golf, and I'm getting addicted to it."

ZF Industries' Project Manager, Robert Paton, says his family also enjoys Alabama's recreational opportunities.

"The number of things to do here is incredible. The leisure activities, the sports and clubs...we've been to the Space and Rocket Center three or four times—the kids loved it."

MERCEDES-BENZ AND SUPPLIERS WITH ALABAMA OPERATIONS



★ = MERCEDES-BENZ U.S. INTERNATIONAL



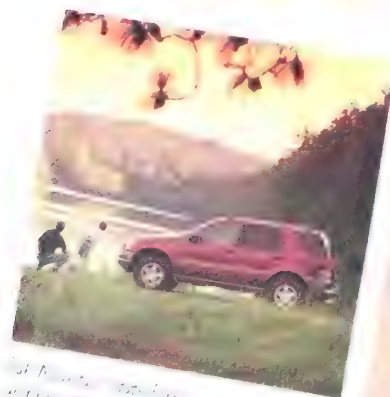
*Off-roading and mountain biking at
Parches Cove near Gunterville.*

As the team member responsible for maintaining the Mercedes-Benz fleet of M-Class press vehicles, Pforzheim, Germany native and Alabama transplant Arthur Rieger has stayed busy since he joined the Mercedes-Benz U.S. International operation.

**// People here are so
WARM and FRIENDLY.**

**My family and I felt right at home
IMMEDIATELY. //**

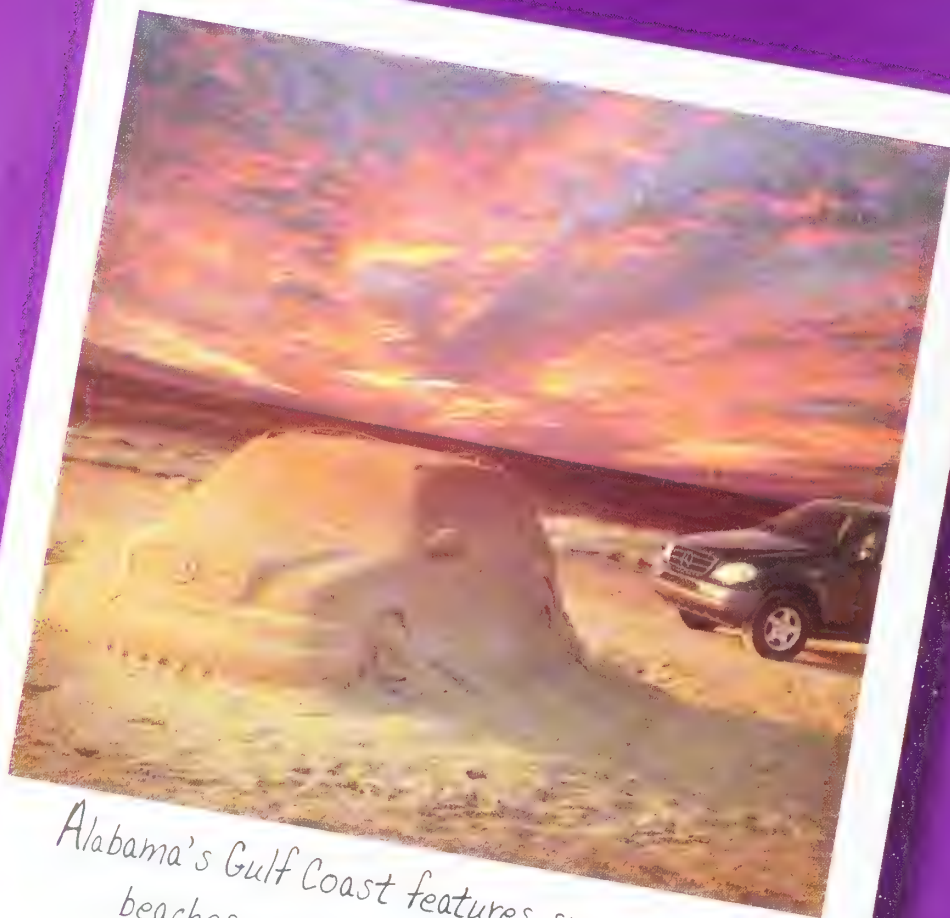
- Arthur Rieger, Mercedes-Benz U.S. International



But everybody eventually gets time off, and he and his family found Alabama to be more than they anticipated. Says Rieger, "There are so many things to do if you want to go out, and at the same time it can be very peaceful if you want to relax." Arthur's family was also surprised by the natural beauty here. "The beaches are very nice. Gulf Shores is beautiful. I've been to France, Spain and Africa, and I've never seen white beaches like Alabama's." He's right. We're home to some of the most beautiful beaches in the world, as well as the lush green of the Appalachian foothills and the cosmopolitan swagger of major cities. It's a place with tropical springs and summers, blazing fall foliage, even the occasional winter snow. In short, Alabama is gorgeous.

But Alabama's beauty goes well beyond looks. It boasts a cost of living among the lowest in the nation, and claims one of America's leading centers for medical research, as well as several highly regarded schools and universities. This is easily one of the more diverse places you'll come across, and people become accustomed to its awesome beauty and the gracious Southern lifestyle which is so prevalent. It certainly made an impression on Arthur Rieger. In his own words, "Living here is very relaxing, and there's not a lot of stress. My whole family likes Alabama very much."





Alabama's Gulf Coast features sugar-white beaches and tropical blue waters.

It seems the folks from Mercedes and its suppliers have discovered something really special in Alabama. And they're not the only ones. In fact, there are more people around than ever who think Alabama is a great place to be. Come here for even a quick visit, and you'll start to see exactly what we mean. Just take a day to drive from one end of the state to the other. Dig your toes into the sand, have some lunch and visit for a while. Around dark, head to the top of the nearest mountain, breathe deeply and stare up at the million little diamonds in a sky that's not quite black and not quite blue. Let the silence wrap around you like a blanket. If you're not already smiling, you will be, because this place is nice. You might even get used to it.

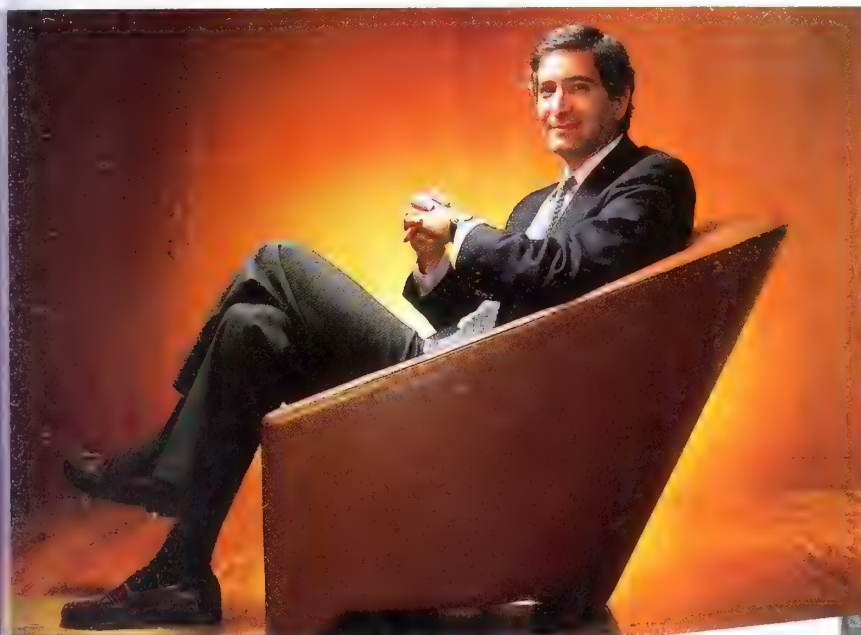
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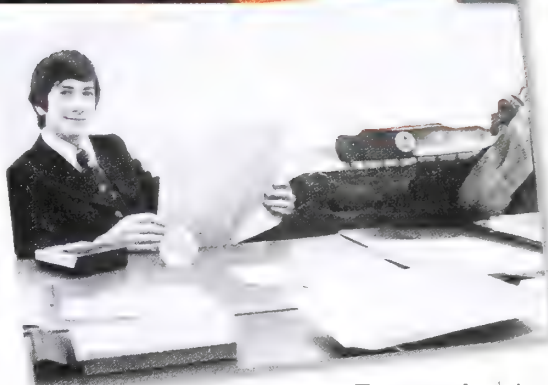
LIKE FATHER, LIKE SON AT COMCAST

These days Brian Roberts is making megadeals of his own



The details had all been set. On a May evening last year in Redmond, Wash., Comcast Corp. President Brian L. Roberts had just nailed a deal for Microsoft Corp. Chairman William S. Gates III to invest \$1 billion of his company's money in Comcast. Just as Roberts was finalizing the transaction, he picked up the phone to call his dad, Comcast founder and Chairman Ralph J. Roberts. "I wanted to tell him we got it," Roberts says. "But I also wanted to get his O.K."

That conversation says much about Brian Roberts. He has worked for his father for 17 years, the past eight as Comcast president. Over time, Roberts, 41, has emerged from his father's shadow to become a savvy dealmaker and industry leader in his own right. But though he now pretty much runs the show, the younger Roberts continues to rely on his dad's counsel at critical junctures. "My father has the golden gut," says Brian. "When you have those moments of 'I don't know,' that's when my father is spectacular."



Fortunately for Comcast, Brian seems to be developing a pretty good gut himself. And he'll need it. With the cable industry undergoing sweeping changes, and Ralph Roberts, now 78, pulling back, Brian is coming into his own at a time of dizzying realignment within the industry. Cable companies are rushing to deliver a huge array of offerings from video to data to phone service as they face stepped-up competition from popular satellite services and, in some markets, telephone companies themselves.

And if it comes off as planned, the pending merger of AT&T and cable giant TCI Group will only heighten the pressure on Comcast and other independent cable companies to pierce new markets. Says Robert P. Norcross, a vice-president at Mercer Management Consulting: "This isn't an easy horse to ride."

So far, the younger Roberts seems to be holding on just fine. His deal with Bill Gates has helped Comcast speed up a three-year, \$1.5 billion upgrade of its cable systems and accelerate the ambitious rollout of new services including digital TV and Internet access. That puts Comcast squarely at the technological forefront of the industry.

HOT PROSPECTS. Roberts is also working hard to bolster Comcast's position in its traditional cable business, where, with 5.5 million subscribers in markets from Philadelphia to Sacramento, it is still dwarfed by rivals such as Time Warner Inc. But the Microsoft deal has allowed Roberts to move swiftly, as in his recent \$700 million deal to acquire a controlling stake in Jones Interchangeable Inc. and its state-of-the-art systems in markets such as Washington, D.C. "I look at Brian as the next true leader in the industry," says William T. Schleyer, former president of cable operator MediaOne Group and now a private investor.

EARLY START

A precocious kid, Roberts read *The Wall Street Journal* in high school and spent summers learning the ins and outs of his dad's company

Already in the wireless phone business, Roberts is now repositioning Comcast to be an up-and-coming telecom competitor as well as a potentially powerful player in entertainment. Earlier this year, he lured one of Walt Disney Co.'s top execs, Steve Burke. Indeed, signing up Burke, a marketing guru on whom Roberts is counting to burnish the Comcast brand, was a huge coup. After building up the popular Disney Store chain and helping to turn around Euro Disney, Burke was on the fast track at Disney and in the running to become president under Chairman Michael D. Eisner. But Roberts sold Burke with his conviction about Comcast's hot prospects. "Most people thought I would never leave Disney," says Burke. "I was even surprised myself. It was really Brian."

The fourth of five children, Brian was a strong-willed kid who always knew

10/1/94
PHOTO BY CAROLYN BAUMAN
FORT WORTH STAR-TELEGRAM

100-YEAR-OLD GEORGE DAWSON WAITS
ON THE PORCH EVERY SCHOOL DAY FOR
HIS TEACHER TO PICK HIM UP.

LIFE IS LONG AND BEAUTIFUL

AT THE AGE OF 100, FORT WORTH GEORGE DAWSON
IS LEARNING TO READ, FELLOW SENIORS IN
FORT WORTH KNOW HIS JOURNALISM
STORY BECAUSE THE STAR-TELEGRAM TOLD
THEM - AND SHOWED THEM THIS PICTURE
OF GEORGE WAITING ON THE PORCH FOR
HIS TEACHER. WHO SAYS NEWSPAPERS
DON'T REPORT GOOD NEWS?

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he wanted to work in the family business. Hypercompetitive and an avid athlete, Roberts was crushed when he was cut from his junior high school basketball team because he was too short. But he didn't mope around. Instead, he insisted that his mother, Suzanne, a former actress and now a child therapist, take him to a doctor to see if anything could be done to speed up his growth, according to his dad. Brian, who says he doesn't remember going to see a doctor, later grew to a lean 6 feet 2 inches.

A precocious teen, he read *The Wall Street Journal* in high school. "He questioned almost everything and tended to believe ideas heatched himself," says Edwin Probert, Brian's English teacher. Fascinated by the stock market, Brian occasionally dropped in on his private school's financial administrator to ask about investments. In college, his zest for finance grew. "He was talking about covered options and all sorts of complicated trades even as a freshman," says Peter Monaghan, co-captain of the squash team with Roberts.

DUMBFOUNDED. As a youngster, Roberts often tagged along with his father at work. And he spent summers learning the ins and outs of the company, doing hands-on work like installing cable, and discovering the downside of being the chairman's son. When he was 15, on his very first day on the job, his boss pulled him aside, saying: "I don't care whose son you are; if you work here, you are really going to work." Although the incident left him shaken, it proved home a lesson Roberts has yet to forget. "You are always the son of the boss," he says. "You can either deal with that, or you shouldn't be there."

If Ralph Roberts had had his way, his son would have first tried his hand outside Comcast. The elder Roberts was dumbfounded when his son passed up

promising offers, including one from an investment bank and the likelihood of another from Goldman, Sachs & Co., after graduating from Wharton in 1981. "He's out of school, and he's hanging around, and he won't go to these interviews. Finally he says, 'You are rejecting me. You aren't getting any younger, and I'd like to have a few years where I can work with you.' I said, 'O. K., Brian, you can start tomorrow.'"

BRIAN ROBERTS

BORN 1959, Philadelphia.

EDUCATION B.S., 1981, in finance, from the University of Pennsylvania's Wharton School.

TEENAGE PASSION Playing the stock market.

WHY HE WENT TO WORK FOR HIS DAD RIGHT AWAY "There's a 40-year gap between my dad and myself. Why miss several very good years learning and having fun working with him at the company?"

HOW THEY SHARE POWER "I'm not going to make a big decision without checking with my father. On the other hand, he would say this is Brian's company. It's a partnership."

BIGGEST BUSINESS REGRET Investing only \$5 million in Turner Broadcasting in 1987 when the cable industry was bailing out the then ailing cable programmer.

BIGGEST PERSONAL COUP Member of squash team that won a silver medal at Israeli Maccabiah Games in 1997.

FAMILY Married; two daughters and a son.

Since that moment, by all accounts, father and son have evolved into an extremely close-knit team as Ralph gradually readied his son to run the company. "Their relationship is one of the most unusual I've seen," says media dealmaker Herbert Allen. "I think they are equal in their mutual respect for each other." Ralph Roberts puts it this way: "The older generation has to be willing to give up some of their prerogatives rather than waiting until you are six feet under."

After spending three years in the field learning everything about local operations, from marketing to building systems, Brian moved to Philadelphia headquarters in 1984. In meetings, he was like "a fly on the wall," recalls Steven Rattner, deputy chief executive of Lazard Frères & Co. and a longtime investment banker for Comcast. "Brian spoke when spoken to and deferred to his elders," says Rattner. That changed as Roberts gained experience, but he never passed up a chance to learn from the pros. Schleyer recalls a trip by a number of cable execs to Japan in the early '90s to examine some new technologies. Roberts, nudged by his dad, made sure to snag the seat next to Tele-Communications Inc. CEO John Malone. "They spoke the entire flight, and no one could get a word in edgewise," says Schleyer.

In 1990, at age 30, Roberts became Comcast's president. Ralph and Brian

We're local, coast to coast, in newspapers...

>The Philadelphia Inquirer

>Detroit Free Press

>The Miami Herald & el Nuevo Herald

>San Jose Mercury News

>The Kansas City Star

>The Charlotte Observer

>Fort Worth Star-Telegram

>Saint Paul Pioneer Press

>Contra Costa Newspapers

>Philadelphia Daily News

>Akron Beacon Journal

>The (Columbia, S.C.) State

>Lexington (Ky.) Herald-Leader

>The Wichita (Kan.) Eagle

>The Macon (Ga.) Telegraph

>Tallahassee (Fla.) Democrat

>The (Wilkes-Barre, Pa.) Times Leader

>Duluth (Minn.) News-Tribune

>Belleville (Ill.) News-Democrat

>Columbus (Ga.) Ledger-Enquirer

>The (Biloxi, Miss.) Sun Herald

>Fort Wayne (Ind.) News-Sentinel

>The (Myrtle Beach, S.C.) Sun News

>Bradenton (Fla.) Herald

>Grand Forks (N.D.) Herald

>San Luis Obispo (Calif.) Telegram-Tribune

>The Monterey County (Calif.) Herald

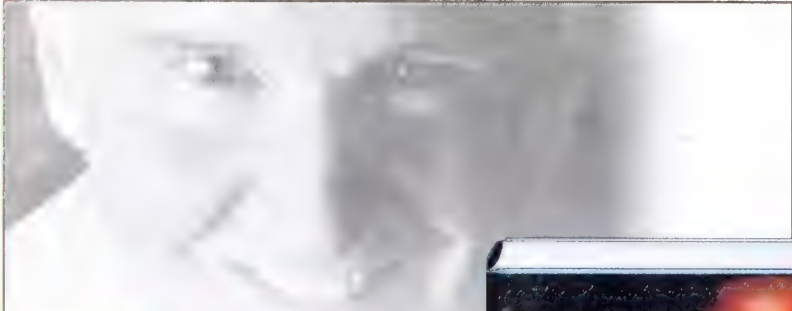
>(State College, Pa.) Centre Daily Times

>Aberdeen (S.D.) American News

>Warner Robins (Ga.) Daily Sun

...and on the Web.





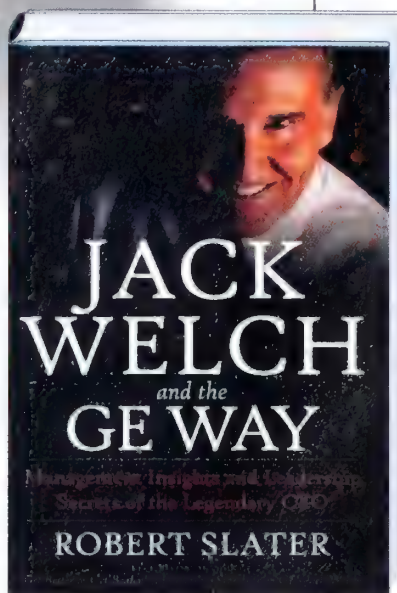
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on page 142

split management duties, with Brian focused on technology and programming. Still, it was Brian who took the initiative to reach outside the company for fresh talent. In 1992, he lured Barry Diller to run Comcast's QVC Inc. home shopping channel after Diller left Fox, though the two eventually split over Diller's ill-fated attempt to buy CBS Corp.

Brian's stature grew when he became chairman of the National Cable Television Assn. in the mid-'90s, and pushed for industrywide standards. Then, he hit the jackpot with the Microsoft deal. Comcast is the single largest investment outside Microsoft that Bill Gates has ever made. And Gates, feared as much by his friends

**"You are always the son
of the boss. You can
either deal with that, or
you shouldn't be there"**

as his enemies, agreed to forgo voting shares, a rarity for him. The deal made sense for the software giant, long frustrated by the failure of phone and cable companies to offer consumers high-speed hookups to the Internet. "The idea was to spur investment in connectivity in the whole cable industry—and that was quite successful," says Craig Mundie, senior vice-president for consumer platforms at Microsoft.

Now, Brian Roberts has to keep up with the wild horse he helped unleash. With his four siblings pursuing other careers, Brian governs his family's 80% voting control, worth about \$400 million. The early-morning-to-late-night hours, broken only for dinner every night with his wife, Aileen, and their three children, aren't an issue. Nor, it seems, is his father's eventual stepping down. Ralph, who comes to the office four days a week, shares adjoining offices with Brian, who often pops in to bounce ideas off him. But though Ralph has no plans to retire, one day Brian's fun "will be significantly diminished when his dad isn't there to share it with," predicts his wife. That no doubt will be true. But Brian Roberts is as ready as he'll ever be to run his father's company.

*By Amy Barrett in Philadelphia
with Steve Hamm in San Mateo and
Ronald Grover in Los Angeles*

In times like these, where can investors find solid ground?

INVESTOR

Excerpted results from Prudential's Investor Sentiment Index, a telephone survey conducted with 444 investors August 28–31.

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It's more than investment success, it's the consistency of our pursuit. Prudential's investment team has earned a Rock Solid[®] reputation among individuals and institutions worldwide. The Prudential approach combines an unwavering focus on long-term results and a careful balance of risk and reward.

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VIRTUAL MANAGEMENT

Computer models may give execs previews of how decisions pan out

Thor Sigvaldason is late. As part of a novel consulting cluster at PricewaterhouseCoopers, he is supposed to be at an important client meeting at 10 a.m. But he has overslept for the session with a top executive of Macy's East.

The other team members run through their paces, and when Sigvaldason finally arrives, 20 minutes late, his brown hair is still wet from a shower. He eases quietly into the room, watched only by his boss, K. Winslow Farrell Jr., 45, whose face doesn't hide his displeasure.

SCI-FI? Soon, though, Thor brings up on a computer screen what has taken the team 1,800 hours to construct. It shows awkward blocklike figures roaming about a crude layout of a department store. The idea is to simulate how real shoppers actually operate in a store. But like bumper cars at a carnival, the little figures bounce off the blue walls. Explains Farrell: "We haven't built certain rules into their brains yet, and they have primitive vision."

The client, Macy's group vice-presi-

dent William M. Connell, is amused and oddly pleased, if only because he can see that the team is making some progress toward an incredibly ambitious goal: to harness the emerging science of complexity, the notion that complicated behavior emerges from the interaction of many components, and create a powerful new tool for top executives. Farrell's team is creating artificial worlds of evolving, reactive software creatures. If all goes well, the actions of those "adaptive agents" will so closely mimic human behavior that managers for the first time will be able to use them to

test the impact of their decisions before implementing them in the real world.

The stuff of science fiction? Well, it may seem a bit far out and abstract. Some of Farrell's own colleagues within PricewaterhouseCoopers think his Emergent Solutions Group is overreaching, trying to invent something out of a pop-science movement. But Farrell sees it as the ultimate "flight simulator" for management—and his firm appears to be the furthest along of several consultants vying to take the con-

cept out of the laboratory and turn it into a commercial business. A handful of corporations are each betting hundreds of thousands of dollars that Farrell can succeed. If he does, PricewaterhouseCoopers expects the tool could be used in a broad range of consulting assignments, generating millions in revenues over the next three to five years.

A SHORT GUIDE TO COMPLEX SYSTEMS

COMPLEXITY THEORY The notion that complicated behavior emerges from the interaction of individual components, each with its own set of rules that guide behavior

ADAPTIVE AGENTS "People" created within a software program who modify their behavior and make decisions in response to the environment that programmers create around them

CYBER-BIOENGINEERING Transferring human characteristics to the adaptive agents



Farrell is trying to create a virtual world where executives could safely test hunches, run scenarios, and preview the impact of big and small decisions—without major investments, public embarrassments, and competitive backfire. Macy's, for example, is hoping the computer model will help it figure out such things as where to place cash registers and service desks to improve sales.

"A SYNTHETIC PUBLIC." The retailer expects a working product by the end of the year. "If we can successfully do the implications are enormous, in terms of time compression, cost, and reputation," says Connell. "You can run a day in minutes and a month in hours. You could see whether investments are likely to pay off or not. And if you make wrong decision in the model, you're on dealing with a synthetic public, not the real world."

Much is riding on the team and the project. Before merging with Price W

The simulations could allow execs to safely test hunches



'LIGHT SIMULATOR' CREW

handful of corporations are each
etting hundreds of thousands of
ollars on Farrell (front) and his
am at PricewaterhouseCoopers

house two months ago, Coopers & Lybrand invested millions of dollars on this cutting-edge dream in hopes that the investment would help differentiate consulting practice from a vast array of competitors. Strong in information technology, it wants to land more high-level strategic work. "It's a way to gain respect and attention in the chief executive offices and the boardrooms where we haven't played before," says John Jacobs, global deputy leader for management consulting services. "If we begin getting good predictions out of it, we're going to have a lot of new clients knocking on our doors."

For years, management has sought to harness the power of econometrics and technology. Operations research and linear programming, however, rarely won the attention of the CEO because they were so esoteric and difficult to grasp. Farrell's group is hoping that the ability to see decisions acted out on a computer screen will greatly help sell the idea in the executive suite. Others agree. "American management is numerically illiterate," insists Michael Schrage, a technology consultant and author. "Instead of selling equations, they are selling pretty pictures. Visualization is the marriage of mathematics and marketing."

MOVIEGOING CLONES. The potential is great. Among others, Citicorp, Coca-Cola, Shell International Petroleum, and Texas Instruments have been sponsoring research into the field of complexity at the Santa Fe Institute in New Mexico, the foremost think tank on this nascent sci-

ence. Already, Farrell's work has attracted more than half a dozen clients who are convinced of the commercial appeal of using artificial life and complexity theory to build these simulations.

US West, for example, is hoping Farrell can create a model to predict how its competitors and customers would react to different pricing plans and promotions. For a major entertainment company, his group has created 40,000 moviegoing agents—cloned from a survey of actual moviegoers—to help executives determine the best way to market and distribute films. Farrell says that the model is up and working, forecasting first-week box-office receipts at accuracy rates of more than 30% better than traditional forecasting methods that rely on historical records.

But Farrell, a former scientist at Caltech's Jet Propulsion Laboratory, has a long way to go before he and his team can broadly transform the way companies plot strategies, plan products, and market goods to consumers. "We're trying to bend metal here," says

Farrell, who joined Coopers & Lybrand 12 years ago after earning an MBA from Columbia University. "We're trying to apply theory to the real world. It requires some heavy lifting."

The skeptics say, moreover, that any computer model is only as good as the assumptions plugged into it. "As you get more complex systems, your ability to untangle the core assumptions becomes more complicated," says Eileen C. Shapiro, author of *Fad Surfing in the Boardroom*. "This could be useful, but only if it is used as an aid to thinking and not a replacement for thinking."

To pull it off, Farrell has put together an eclectic bunch of brainy misfits and rebels who quietly labor in the button-down culture of a highly conservative accounting firm. It's a group of 22 people you'd more likely find in Silicon Valley than on the third floor of a New York skyscraper on Sixth Avenue.

The core group of thirtysomething

scenarios without major investments—and embarrassments

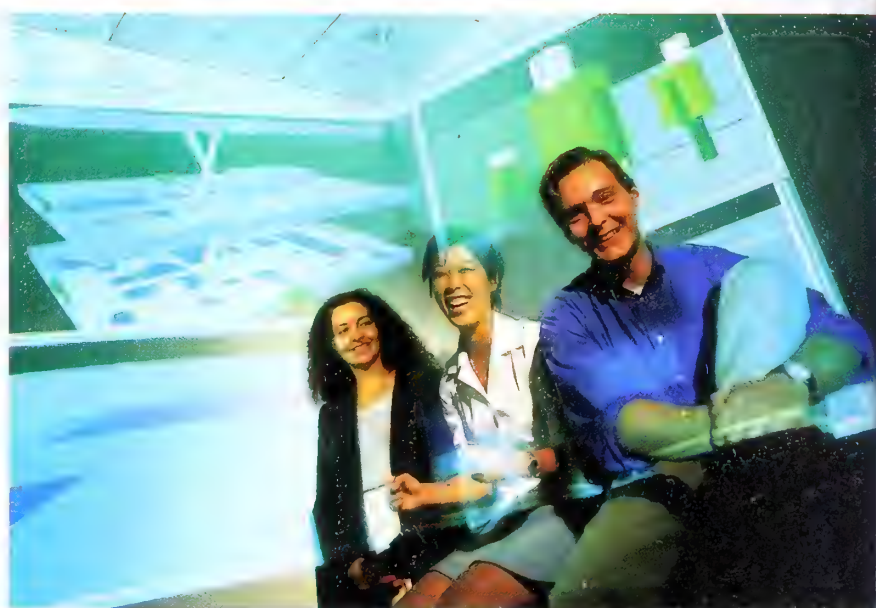
brainpower includes Robert Bernard, 31, whose résumé shows degrees from Princeton University in psychology and from the University of Michigan in urban planning; Radoslaw "Radek" Zapert, 31, an intense Polish mathematician; Wei Lin, 31, a former staff sergeant in the Taiwanese military police who has a PhD in electrical engineering; and George M. Janes, 32, a self-described "classic data geek," called "the stable boy" by his colleagues because he maintains the agent population in several simulation models.

ARROGANT EGGHEAD? Like Sigvaldason, 31, whose forte is visualization, many are unaccustomed to working in a corporate setting where they have to attend meetings on time, wear suits, and keep their hair neatly trimmed. Until several women joined the group, a couple of team members would show up for work in flannel shirts, jeans, and hiking boots, then strip in the lab to slip into suits for meetings.

In the windowless lab room, it's not unusual for profanity to be heard in an array of languages. The work is often long and tedious. Sometimes, team members toil until the wee hours of the morning to debug some software or meet a client deadline. Wei says his wife often scolds him for coming home late, and he wonders whether his nearly 2-year-old son recognizes him. But they're a passionate group, driven by their desire to do pioneering work. "This is not just a toy world in academia," says Bernard, who came aboard as Farrell's first employee in 1995 wearing a ponytail and an undersized charcoal-gray suit. "We're pushing the envelope."

Farrell knows how it feels to be an outsider. When he was up for partner at Coopers & Lybrand in 1993 after leading multimillion-dollar reengineering assignments at both AT&T and Nynex, he was rejected by some as an arrogant egghead. Several of the firm's old-line accounting partners could hardly understand what Farrell was talking about when he spoke of "adaptive agents" and "cyber-bioengineering," a term Farrell uses to describe the creation of his computer agents. With the help of consulting chief Jacobs, Farrell overcame their skepticism to win partnership status.

It was while managing the Nynex project that Farrell stumbled onto the then-emerging field of complexity. Seeking new ways to better organize the telephone company, he flew out to the Santa Fe Institute and met with some of the field's leading thinkers. Farrell returned mesmerized by the possibility of applying their theories to business.



WHAT MACY'S HOPES TO GAIN

Consultants Iris Ginzburg, Anita Shieh, and Thor Sigvaldason (above) have created an elaborate computer model of a Macy's store filled with hundreds of "synthetic" shoppers. By watching how they interact, the retailer hopes the system will allow it to make risk-free decisions such as:

- The number of salespeople needed in each store department to maximize profits
- How to turn browsers into shoppers
- Where to locate service desks and cash registers to increase sales

With others, he developed in 1994 a software simulation called TeleSim, a primitive, stripped-down precursor to the computer models he is now building. A year later, he gained funding from Coopers to launch his group.

Modeling complex, adaptive systems that mimic the marketplace is tough work. The team spends thousands of hours writing computer code to embed humanlike properties in the intelligent agents they create. The agents are modeled on consumer research surveys and databases of information. The virtual customers in Macy's model will be given characteristics such as sex, age, how much they buy, and when, from credit records and thousands of pages of cash register data from eight Macy's stores.

Farrell and others believe that by making these agents react to each other,

they will provide more predictive results. "The value of this interaction is that you can build in much more real-world behavior," says W. Brian Arthur, a preeminent guru in the field who recently joined Farrell's team from the Santa Fe Institute. "It's like chemicals reacting in a test tube. You can have atoms tumbling around, meeting each other, interacting, and interleaving, and all that kind of thing."

GLITCHES. Still, it's easy to overlook things humans take for granted—and that may be the biggest hurdle Farrell faces in creating a practical management tool. In an early iteration of the model built for the entertainment company, almost all the agents rushed out to see a movie in its first week. The reason: The consultants failed to account for whether the agents had enough leisure time to go to the movies.

Or consider the complications of creating a make-believe Macy's. At preliminary design meetings, Farrell and a team assigned to the Macy's project wonder what impact a sales associate's age, gender, length of service, and salary might have on consumer sales. Or, how to factor in the different demographics for Macy's Herald Square store in New York and a mall store in White Plains, N. Y.

If Farrell's team can deliver on the promise of these new concepts, they will likely give birth to a new and powerful management tool that could change the way executives manage their companies. But they have many daunting hurdles to overcome—starting with the need to show up on time for those client presentations.

By John A. Byrne in New York

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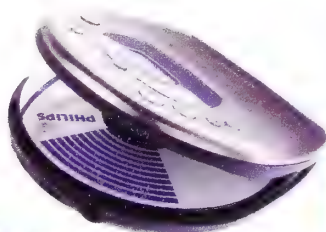
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TIMES SQUARE: Campaigns can be created in days

ADVERTISING

BILLBOARDS AREN'T BORING ANYMORE

Going digital has sent costs down and creativity way up

You would think Los Angeles commuters had seen it all. But last May, a 14-story building with a hole in it stopped traffic on the eight-lane 405 freeway. Turns out the patch of sky blue in the center of the office building was an illusion—the latest in outdoor-advertising wizardry. Walt Disney Co., promoting its summer action movie *Armageddon*, had ordered the mock hole to simulate the path of a meteor. Traffic officials were not amused. Disney took it down.

Outdoor ads are attracting more than commuter attention. The industry that was once the low-rent cousin to network TV and other livelier media is enjoying a renaissance. Lower costs, faster technology, and a surge of creativity have pushed outdoor—that's everything from billboards to bus shelters—into renewed prominence. "It's ironic. Scribbling a message on a wall has to be the very first form of advertising—back to the cave-man. Yet here it is again as the latest

hoopla," says Jack Irving, media director for Saatchi & Saatchi Advertising Worldwide's New York office.

Indeed, fueled by scorching demand from heavyweight national clients such as Sony and Microsoft, outdoor ad revenues are hitting new heights. With double-digit growth expected this year, the Outdoor Advertising Assn. thinks spending will exceed \$2 billion. That will best last

It has also set the stage for an influx of creativity. With designers able to dream up projects that would have been impossible to build a few years ago, a host of head-turning billboards are cropping up in major cities. In New York City, fake fir trees appear to grow out of Poland Spring's billboard. Meanwhile, Dayton Hudson Corp. has purchased a series of exotic boards over the last two years, including one for Valentine's Day candy which wafted a mint scent for blocks in downtown Minneapolis. "You can go for the big idea," says Irving. "You can start with an ad and make it an attraction."

BIG NAMES. There's another powerful lure for advertisers: lower cost. Computer printing of outdoor ads has slashed costs by approximately 10%. That's one reason the California Milk Board has run more than 400 billboards to promote the state's cheeses. The costs, says the state's ad agency, McCann-Erickson Worldwide, ran an estimated \$5 to \$6 per 1,000 view-

ers—about half what a newspaper ad would cost. Lynne Scott, an associate media director at McCann, says that for \$20,000—the cost of a 30-second spot on a *Seinfeld* rerun—she purchased weeks of publicity with a billboard at the base of the Golden Gate Bridge.

Such advantages are drawing some of the

BACK ON THE BOARDS

AMERICA ONLINE Bought its first outdoor ad this summer, sticking its logo on New York City buses

PENNZOIL Returned to outdoor advertising, lured by a CBS package deal including network, cable, radio, and nationwide billboard spots

CALIFORNIA MILK BOARD Found that a billboard near the Golden Gate Bridge delivers more eyeballs than a *Seinfeld* rerun at the same price

Finding the right solution means looking beyond the obvious. Examining things more closely. Questioning appearances.

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Marketing

biggest names in marketing. While entertainment companies such as Sony Corp. and ABC Inc. have long used billboards, their spending soared 24.6% last year, to \$206 million. And many newcomers—particularly technology companies—are advertising outdoors for the first time. Microsoft Corp. started dabbling in billboards last year to support its brand campaign, "Where do you want to go today?" This year, it launched a 10-city billboard and bus campaign for Sidewalk, its arts and entertainment service.

The lure of billboards is simple: It's one of the few places big names have yet to slap with their logo. America Online Inc. bought its first outdoor ads in August on the sides of New York City buses in an effort to become "ubiquitous," says Marshall Cohen, senior vice-president for brand development.

All of this advertiser excitement has generated a flurry of acquisitions in the outdoor industry as big media companies have gobbled up many of the smaller billboard owners. CBS Corp. and Chancellor Media Corp., the radio outfit controlled by Dallas investment bankers Hicks, Muse, Tate & Furst Inc., have purchased outdoor-ad companies in the past year. Clear Channel Communications Inc. paid \$1.15 billion this year for Phoenix-based Eller Media Inc.

COORDINATION. For media moguls, owning billboards allows them to be bundled into a larger package that increases billings. CBS persuaded Pennzoil Co., which has put most of its recent ads on TV and radio, to commit new dollars to buses and billboards. One reason: CBS was able to provide a package deal of network, cable, radio, and newly acquired outdoor space in 11 cities. As a result, CBS boosted its revenues 15%, to \$25 million. "If we can tell an advertiser we are likely to get to more consumers by coordinating the approach among radio, TV, cable, and the outdoor market, we can sell them on being that much more effective," says Lloyd Werner, executive vice-president of CBS' cable unit.

That means consumers are likely to see more billboards in the future—in unusual places. Building-wrapping, à la the *Armageddon* ad, is all the rage in Los Angeles. ABC has plastered hot-dog and coffee-vendor carts in 15 cities with its sardonic promos for the upcoming fall TV season. Online bookseller Amazon.com put ads on trucks and outside rival Barnes & Noble Inc. bookstores in several major cities. Guerrilla tactics? As new marketers and big media companies swarm in, it's inevitable.

By Ronald Grover in Los Angeles



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First Read of Decision Makers



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Microsoft
Where do you want to go today?

With sales of Japan's bland sedans
on a slide, carmakers are
not just restyling. They're inventing
whole new classes of vehicles

A white SUV is shown from a low angle, driving up a sandy dune. The vehicle is white with black plastic trim on the lower body and wheels. The background is a clear blue sky and a distant, hazy mountain range.

JAPANESE CAR DESIGN

Tatsuhide Hoshi is the kind of young customer Toyota Motor Corp. wants. He's 29. He's hip. And he has cash. But he doesn't like a single car in Toyota's lineup enough to buy one. He believes Chevrolets have more style—old Chevrolets, that is. He drives a 1961 Corvette. Funny thing is, Hoshi is also a Toyota designer. Only a year ago, for a Toyota employee to admit to a Corvette obsession would have seemed like treason. But

Hoshi's boss recruited him from headquarters to join a team of young designers in Tokyo's trendy Sanganjaya

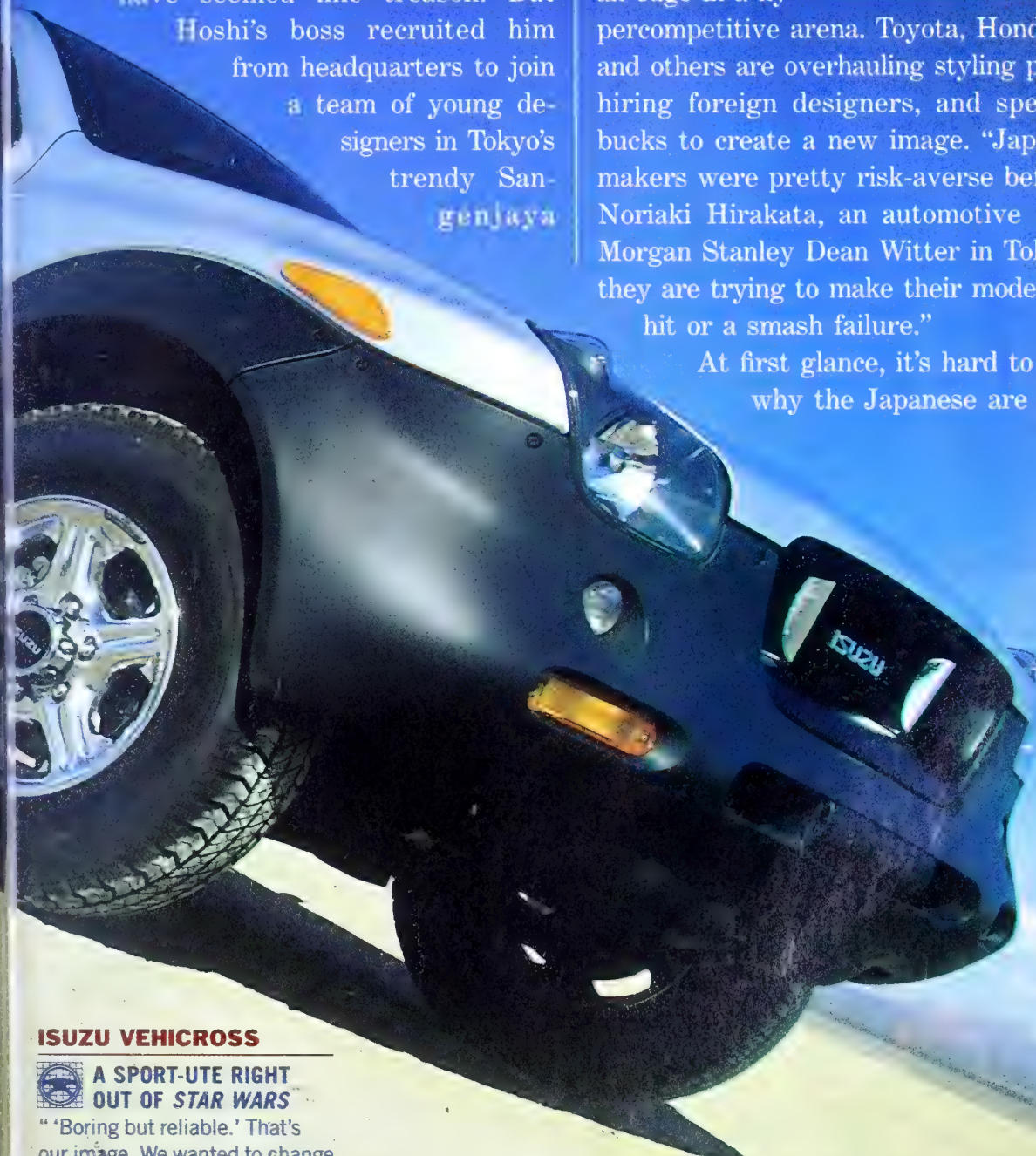
district precisely because Hoshi doesn't like Toyotas. Hoshi has been working on the interiors of such models as the Premio and Corolla. But someday soon, he may be styling entire cars for young customers of the company brand.

Hoshi is one player in the Japanese car industry's newest high-risk game: creating daring designs that give carmakers

Design

an edge in a hypercompetitive arena. Toyota, Honda, Nissan, and others are overhauling styling procedures, hiring foreign designers, and spending big bucks to create a new image. "Japanese carmakers were pretty risk-averse before," says Noriaki Hirakata, an automotive analyst at Morgan Stanley Dean Witter in Tokyo. "Now they are trying to make their models a smash hit or a smash failure."

At first glance, it's hard to figure out why the Japanese are getting so



ISUZU VEHICROSS



A SPORT-UTE RIGHT OUT OF STAR WARS

"'Boring but reliable.' That's our image. We wanted to change that," says Isuzu's design chief

DEAN SIRACUSA



hot and bothered. After all, bland is beautiful for them. The looks of the Honda Accord and Toyota Camry are the equivalent of a gray flannel suit. But their solid performance makes these sedans perennial contenders for the top-selling car in America, while equally bland models such as the Corolla compact are crowd-pleasers in Japan. Why tinker with success?

The short answer: Because success, even for Japan's best, can be fleeting. Auto executives already see a disturbing trend: "The traditional sedan is fading out," says Katsuhiko Kawasoe, president of Mitsubishi Motors Corp. Sales of medium-class sedans in Japan, the backbone of the market, have shrunk to 28,000 vehicles a month, down from 52,000 just four years ago. Old favorites, such as Toyota's stodgy Mark II, just aren't selling. And the Japanese recession is making it imperative to come out with breakthrough products. By the end of this year, 7 of Japan's 11 auto makers will probably be in the red, with only Toyota and Honda showing real strength.

Design

What is happening in Japan could eventually affect Camrys and Accords in the U.S., where pickup trucks, sport-utility vehicles, and minivans have been encroaching on sedans for a decade. Chrysler, Ford, and General Motors' Cadillac are also putting a lot more emphasis on design. In January, Cadillac will unveil the Evoq, a two-seater concept car that features sharp-edged, postmodernist styling. And in Europe, the Japanese face an even bigger challenge: They will have to go head to head with Volkswagen and Fiat in the market for compact cars, a category the Europeans dominate on their home turf.

LOOK-ALIKES. So if younger, budget-conscious drivers are unwilling to plunk down money for a me-too car, the Japanese see new design as the only way out. "Styling will become the most important point for selling cars," reasons Yoshikazu Hanawa, president of Nissan Motor Co. "Before, it was important what type of engine or suspension you had. But now, people pay attention to the distinctiveness of the design." In that area, say competitors, the Japanese have a long way to go. Says Helmut Panke, a member of BMW's management

HONDA S-MX



"LOVE HOTEL ON WHEELS"

Though a compact wagon, it has the space to handle bulky sports gear. The designers wanted seats that were as comfortable as a sofa—and that could turn into a bed

board: "If you take the label away [from a Japanese car], you don't know if it's a Mitsubishi, a Toyota, or a Honda."

Ouch. That hurts. Sort of true, though. The Japanese, however, are determined to play catch-up. On one level, that means a tremendous diversification in the lineup. Just three years ago, Honda had only sedans such as the Accord and Civic. Now, it's

churning out a whole range of minivans and sport-utilities, and a convertible roadster is next. Toyota, too, is spreading its wings. Think of the \$16,000 Toyota RAV4, which introduced a bubbly, playful body to the sport-utility category and became a hit. And there's the \$16,500 Toyota Prius, the hybrid gasoline-electric car that has such a short front hood a driver can hardly tell there's an engine there.

Carmakers will unveil an estimated 64 new models this fiscal year in Japan, more than twice as many as last year. The efforts fall into several categories. First, there's the development of a new category of "crossover" vehicles that merge the attributes of sport-utes, vans, and cars. Another move is to add nicely styled alternatives to such old standbys as the Corolla. A third tactic is to revolutionize car interiors to make maximum use out of every cubic inch. And another is to play with the look of Japan's minicars—those tiny vehicles that make up 25% of light vehicle sales

there. Many are now sporting superhigh hoods that give them a funny,

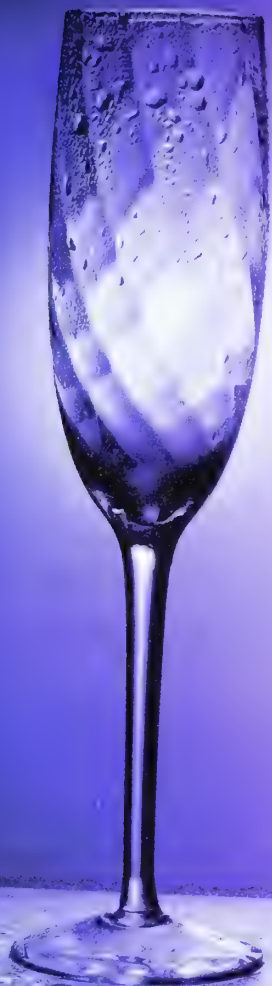
TOYOTA YARIS



A SNUB-NOSED SUBCOMPACT

Designed in Brussels, this concept car has nothing in common with the Camry. If it works, the stubby Yaris will revolutionize the look of tiny Toyotas everywhere





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BOSCH

boxy look that appeals to young buyers.

The cross-breed vehicles offer a good view of the new approach. The idea is to build sport-utes and vans on car platforms for easier handling and then jazz up the styling. These car-truck crossovers should soon be the fastest-growing segments of the auto markets in both Japan and North America. Mutant sport-utes and minivans account for an estimated 20% of Japan's light-ve-

Design

hicle sales. At the top of this heap is Toyota's \$34,000 Lexus RX300, known as the Harrier in Japan. It competes with Mercedes' M-Class with looks that are sporty but sleek enough to be parked in front of the best hotels. But unlike the Mercedes, the RX300 has a car chassis. The vehicle is a big hit, selling more than 37,000 in Japan since its appearance in late December. It's also leading Lexus sales in the U.S.

NISSAN CUBE

A BOXY LOOK FOR MORE HEADROOM

The space revolution extends to exterior styling in subcompacts. The Cube has a superhigh roof for such a tiny car and sports an offbeat, cubish profile



its new \$22,300 VehiCross to leave no doubt that the company could dream up radical designs. "'Boring but reliable.' That's our image. We wanted to change that," says Shiro Nakamura, general manager of Isuzu's design center. The VehiCross may be too revolutionary for Japanese, who still prefer the utilitarian Wizard sport-ute. But Isuzu hopes Californians will be more receptive when the VehiCross arrives there next year.

Japanese carmakers also are rewriting the rules for interiors. Younger Japanese buyers see their vehicles as an extension of their living room, yet they also want small vehicles to navigate Japan's narrow, crowded roads. That's a tall order. Honda Motor Co. designer Tomoko Ogawa knew that when she was ordered to make enough room for passengers to stretch out or pack their bicycles in Honda's new \$10,800 Capa miniaturized minivan. "We threw out many different designs," she says. Yet with forward-sliding rear seats and a front seat that can fold down into a table, she helped produce a hit that has sold 24,000 vehicles since April.

The space revolution extends to the exterior styling in minicars and compacts, with the Japanese devising a boxy look that adds headroom and de-

TOYOTA NADIA

THE "MONOSPACE" SEDAN

The rounded hatchback gives the car a futuristic look. Meanwhile, the raised roof makes it look more like a mix between a station wagon and a sport-ute than a sedan



parts radically from rounded aerodynamic forms. Nissan has racked up sales with the \$9,000 Cube. It has

a superhigh roof for such a tiny car and sports an offbeat, cubish profile. In the same vein, designers of the \$15,000 Honda S-MX, for example, envisioned a "barn" on wheels that could carry a young couple's bicycles and surfboards but that would also feel as comfortable up front as a sofa. Executive Chief Engineer Yoshio Ui and 31-year-old designer Jiro Ikeda designed a boxlike interior that could handle sports gear and seats that could turn into a bed. The S-MX's popular nickname: "love hotel on wheels." Says Ikeda: "It's just a box. But I wanted it to stand out."

RADICAL SEDANS. The car companies also want to reach out to foreign customers. At Toyota's European Design Center in Brussels, designers are styling cars that can replace Toyota's traditional rounded, sober look and compete with the broad-shouldered German design of the Volkswagen Passat, the Opel Astra, and the Audi A4. "We needed to come to Europe to learn this," says Tadao Otsuki, director of the center. A Brussels-designed concept car, the Yaris, is the inspiration for the subcompact Toyota will roll out in Europe and Japan next year. The Yaris has a stubby, snub-nosed look that has nothing in common with the Camry. Nissan is looking abroad, too. In the U.S., Nissan's 50-designer studio will have design authority over 85% of the vehicles rolled out in North America by 2001.

As Toyota, Honda, and Nissan spin out new minivans and sport-utes, the big question is whether the mainstream sedans will go radical too. While the Accord, Camry, and Nissan Altima will not start sporting way-out looks in the next year, they may look quite different in the next three years. "The present design of the Camry is too soft," says Toru Kimura, general manager at Toyota's design center in Nagoya.

A taste of things to come is the summer launch of Toyota's \$16,300 Nadia, which it dubs

LEXUS RX300

TOP OF THE LINE IN SPORT-UTE CARS

Known as the Harrier in Japan, it competes with the Mercedes M-Class—with looks that are sporty but sleek enough to park in front of the best hotels



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the "monospace sedan." Its sharply lined doors, short overhang in front, and rounded hatchback lined with Jetson-like rear lamps give the car a futuristic look. Meanwhile, its raised roof makes it look more like a mix between a station wagon

Design

and a minivan than a sedan. So far, the Nadia is off to a so-so start, selling 2,000 units a month. But Toyota is patient: It wants to keep advertising the Nadia and build a customer base for it, to capture more of those buyers who have drifted away from the Camry and Mark II.

Meanwhile, the designers are getting stranger, too. Mazda Motor Corp.'s chief designer has colleagues study crystals,

lakes, and deserts to observe "harmony in tension" and apply it to their work. Near Tokyo's Ginza, a battalion of British, Italian, Japanese, and Korean designers have analyzed everything from Honda's role in world history to the evolution of man to come up with new Honda contours. They even consulted architects and artisans on how traditional crafts, such as lacquerware, can improve Honda interiors. "We must clean our designers' minds," says Honda designer Masahito Nakano. Sounds odd. But Zen and the art of automotive design could raise car styling to new heights.

By Emily Thornton in Tokyo, with Larry Armstrong in Los Angeles, Keith Naughton in Detroit, David Woodruff in Frankfurt, and William Echikson in Brussels

TOKYO'S SNEAKIEST CAR BUFF



If you really want to know what new models the Japanese are launching, don't haunt car shows or dealerships. Just check out *Magazine X*, the book for car buffs. Leaf through, and you'll get pictures and descriptions of models that won't hit the road for months, maybe years.

This advance information comes courtesy of the magazine's mild-mannered editor, Shigeo Makino. His office in a rundown section of Tokyo is unimpressive. But the photos and sketches of carmakers' upcoming models are testimony to his doggedness. Other Japanese reporters carefully honor the strict embargoes imposed by carmakers on all information related to new products before the official launch. But Makino cheerfully runs spy sketches and photos of new models, many of them taken with telescopic lenses the size of a man's arm. "It gives me a headache," says Akihiro Wada, exec-

DOGGED SPY

Makino serves up scoops on new models in this ultimate 'zine for motor fans

utive vice-president in charge of research and development at Toyota Motor Corp. Yet Wada is a regular reader of the magazine, which has 300,000 subscribers in Japan and 3,000 abroad.

Makino, 40, and his 12 reporters think embargoes are silly barriers to information that consumers deserve to have. Carmakers often ban Makino and his staff from news conferences, so *Magazine X* depends on deep-throat sources in design offices. The magazine has a scoop hotline for any traitors willing to divulge the name, dimensions, or better yet, a photo of a new model. It will pay several thousand dollars for a snap-

shot of a car that has never been seen. But Makino insists that most leaks come free. "Designers invest many years into developing their cars," he says. "They want people to see their work. It has nothing to do with money."

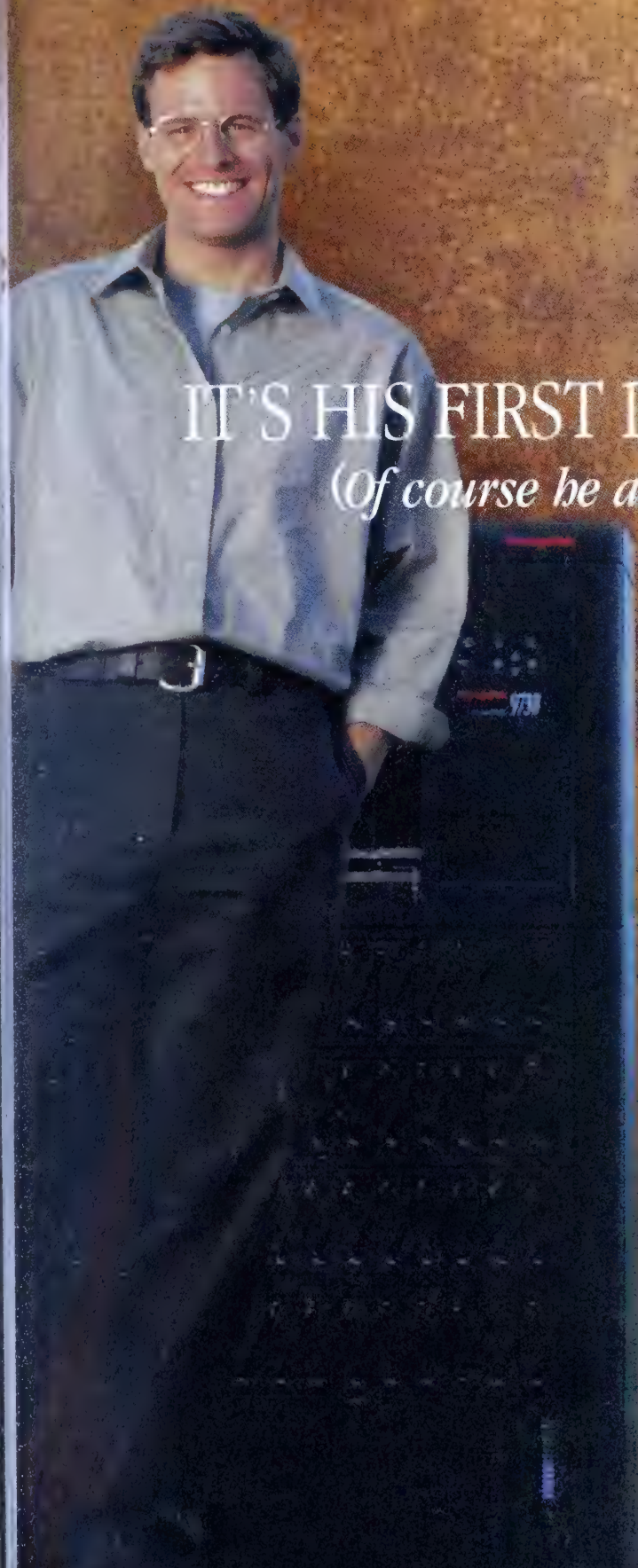
BUM STEERS. There's no question that Makino stays ahead of the curve. "Sometimes we learn that Toyota is developing a new model from the magazine," admits Toyota spokesman Koki Konishi. Makino claims all information is triple-checked: He does not want to give the carmakers any chance to attack his credibility.

Not all scoops come from a phone call. Unlike in the U.S., there are few opportunities to sneak a peek at new models—since Japanese carmakers generally test cars only at night. And there is no Japanese Death Valley, an easily staked-out place where new cars get put through their paces. So the magazine has developed a manual that details locations and hotel rooms that overlook carmakers' secret test tracks.

Every once in a while, the magazine gets a bum steer. In its September issue, *Magazine X* apologizes for reporting that Honda's new sport-utility was a few inches longer than it really is. The irony is that the sport-ute hasn't yet hit showrooms, but somehow, *Magazine X* already knows it goofed. Or maybe Honda shortened the hood just to trip Makino up?

By Emily Thornton in Tokyo





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BASEBALL

HOLY COW, WAS THAT A \$25 MILLION HOMER?

The home-run race could be a bonanza for McGwire. It already is for baseball

The guy with the awe-inspiring home-run swing and the league-leading biceps soon may be setting the pace in another category: endorsement dollars. Mark McGwire, the new emperor of long ball, is a cinch to become the highest-paid corporate spokesman in baseball history should he decide to cash in on even a fraction of the opportunities that beckon.

Thanks to his record-breaking 62nd home run on Sept. 8, McGwire could reap \$25 million in single-season endorsements next year, predicts Rick Burton, director of the Warsaw Sports Marketing Center at the University of Oregon. That would catapult the St. Louis Cardinals slugger past baseball's reigning corporate pitchman, Baltimore's Cal Ripken Jr. (\$6.5 million), and into the company of such Madison Avenue heavyweights as Tiger Woods (\$24 million) and Michael Jordan (\$47 million). Chicago Cub power man Sammy Sosa, who's on pace to also pass Roger Maris' 37-year-old record of 61 homers in a season, figures to play well with advertisers, too.

ONE SNUB. "McGwire has dominated the front-page news for the past two months," says Burton. "You don't have to explain him in your advertising. Not his sport. Not what he did. Just show him." McGwire's raw power on the field, combined with a reputation as a concerned citizen and a divorced but devoted father off it, are a potent combination. And fans have shrugged off his one controversy—the revelation that he uses a muscle-building supplement banned by the Olympics and by the NFL.

So McGwire is likely to be courted

by major corporations in such categories as cars, soft drinks, fast food, and footwear, say the experts. Bill Mul-lon, president of ProSports Marketing Inc. in Fort Lauderdale, Fla., calls McGwire the perfect pitchman for everything from credit cards to sport-utes. "He's Middle America," says Mul-lon. Not that the red-bearded wonder will say yes to all. Already, he seems to

never seen anything remotely close to this. The interest is enormous."

However, Sosa is a lesser known quantity than McGwire, who has already proven to advertisers that he can influence customer spending. Since mid-July, turnstiles have spun wherever he plays. Attendance at Busch Stadium in St. Louis this season is on track to top 3.1 million, even though

the Cards have been out of their division race for months. For their visit to Milwaukee on Sept. 18-20, Brewers' ticket sales are likely to top 150,000, breaking a 20-year-old record for a three-game series.

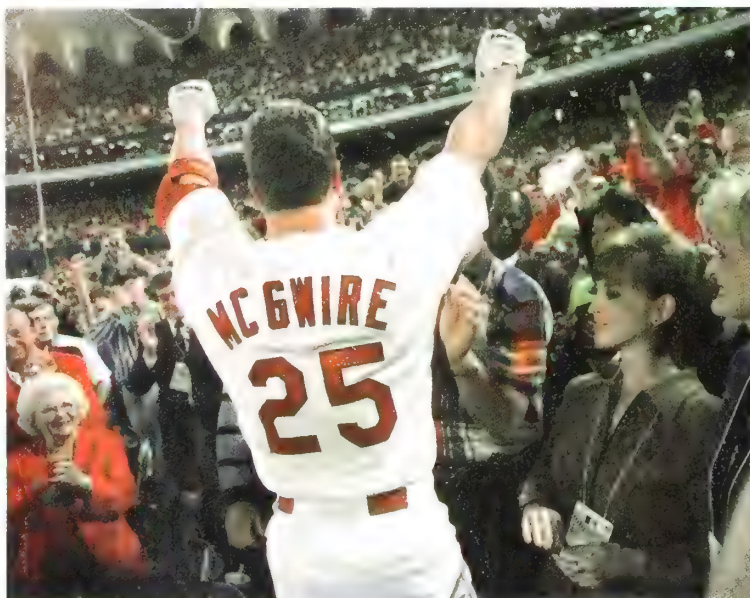
Baseball equipment makers also have been busy. St. Louis-based Rawlings Sporting Goods Co. has rolled out two limited-edition McGwire bats this year, including 1,998 souvenirs commemorating Big Mac's 400th career home run that sold out in a week, at \$129.95 a pop.

Demand for McGwire T-shirts and trinkets also has been brisk, and not only in St. Louis. At Pittsburgh's Three Rivers Stadium last month, concessionaire Aramark Corp. sold out of McGwire items—849

baseballs, 1,400 pennants, and 432 T-shirts—two games into a three-game series with the Cards.

Rivals are determined not to be caught short. Sportservice, which supplies ballparks in St. Louis, Milwaukee, and Cincinnati, has loaded up a tractor trailer with souvenirs for stop along the McGwire trail. Running love on McGwire merchandise, says Tom Olsen, Sportservice general manager at County Stadium in Milwaukee, "would be like running out of beer."

By Mark Hyma



SULTAN OF SELL One marketing pro calls slugger McGwire the perfect pitchman: "He's Middle America"

have squelched what may have been the most lucrative of all deals, a hookup with McDonald's Corp. ("Did somebody say McGwire?"). He told *Sports Illustrated* recently he had no interest in shilling for the chain, since "I don't eat Big Macs."

But Sosa isn't snubbing McDonald's, having traded on his cross-cultural appeal in a recent ad for the rollout of Spicy Mighty Wings. And there's more where that deal came from. Says his agent, Adam Katz: "I've been representing athletes for 14 years and have

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THE EX-HIPPIE VS. 'MY THREE SONS'

In Minnesota, a test for the conservative revolution



LONG, STRANGE TRIP Former Democrat and war protester Coleman has become a darling of the Right

Tucked away in Minnesota, 1,000 miles from scandal-wracked Washington, may be this year's most entertaining election. It features a hippie turned Republican who grew up in Brooklyn, N.Y., a pro-wrestler turned politician who was mayor of Brooklyn Park, Minn., and "My Three Sons"—Mike Freeman, Skip Humphrey, and Ted Mondale—heirs to the most famous names in Minnesota politics.

Obscured by all the personalities in this gubernatorial race, however, one of the most symbolic elections in the country is emerging. It is a race that will help determine how far the conservative movement has come. At its heart is a question being asked around the nation: Should states, flush with huge surpluses after seven years of economic expansion, embark on costly new initiatives or should government keep shrinking?

Nowhere is the question starker than in Minnesota, which taxes its citizens more than any other state. For the first time in 20 years, Republicans here have united behind a single candidate—one supported by both religious conservatives and Big Business. He is Norm Coleman, the boyishly handsome former New Yorker who was elected mayor of St. Paul in 1993 as a conservative Democrat and switched to the GOP before being reelected last year. **"DISCONNECT."** His plan: cut taxes, scrap regulation, and privatize government functions as he did in St. Paul. "There has been a sea change," Coleman says. "People have begun to see the disconnect between their own existences, where they're forced to make do with less, and government, which is immune."

Come November, he will face one of five Democrats running in a Sept. 15

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Government

primary. Although all five say they will cut taxes, they have proposed a range of traditional Democratic ideas, from raising the minimum wage to offering free college education. "There's a fight for the ideological soul of the place," says Donald F. Kettl, director of the University of Wisconsin's Robert M. La Follette Institute of Public Affairs.

The debate here over how much to take back government in good times is similar to others playing out across the country and would be unremarkable if

why every candidate is proposing tax cuts that will amount to a few hundred million dollars a year.

Nobody, though, talks cuts more than Coleman. He wants to permanently cut the income tax and pass a law requiring surpluses to be returned to taxpayers. He also wants to privatize some services and open others up to the competition. He followed a similar path in St. Paul, and employment rolls swelled as the city lured businesses.

Democrats, for their part, say Coleman ignores workers and farmers struggling to keep up in the New Economy. "Mr. Coleman in many ways would move us back to the 19th century," argues Humphrey. Critics also note that while Coleman talks about shrinking government, he supports subsidies for sports stadiums, such as the new hockey arena in St. Paul.

Certainly, Coleman's transformation has been a long, strange trip. He spent a decade as one of Humphrey's key deputies in the state attorney general's office and, while a Democrat, co-chaired ultraliberal Senator Paul D. Wellstone's reelection campaign. And that's nothing compared with his long-haired college days, when as a Vietnam War protester at Hofstra University he wrote a piece in the student paper saying conservatives "don't [have sex] or get high like we do."

But Coleman now calls the "excesses" of his generation "plain, simply wrong"—and even advocates chastity before marriage.

He also speaks out against abortion and argues that citizens should be able to carry concealed weapons. Republicans seem convinced. In fact, they may be most encouraged by his candidacy's unification of the Christian Right and Big Business.

Still, defeating Humphrey, the likely Democrat nominee, wouldn't be easy. He is running on both the \$6.1 billion settlement that he wrested from tobacco companies and, of course, his name. But in a year when turnout is likely to be low, Coleman has a chance to become a poster boy for the kind of candidate Republicans dream of. That he's running in Minnesota, birthplace of so many liberal icons, would make a win all the sweeter for conservatives.

By David Leonhardt in St. Paul

LIKE FATHERS...

Second-generation Democrats all promise to cut taxes but also float a variety of traditional party ideas, such as raising the minimum wage



MONDALE



HUMPHREY



FREEMAN

is weren't Minnesota. Over the years, high taxes have helped pay for a relatively strong education system, and has produced liberal standard-bearers such as Hubert H. Humphrey and Walter F. Mondale, each of whom has a son in the current race. (Mike Freeman's father, Orville Freeman, was Agriculture Secretary in the 1960s.) "Politics different here," says Wy Spano, editor of a political newsletter. "We have not moved as far to the conservative end of the spectrum as other states have."

IX TALK. But as the political winds have started to shift, candidates here have responded. "Most people don't live a trust in government to do things right," says Mondale, a former state senator and one of the more conservative Democrats in the primary. That's



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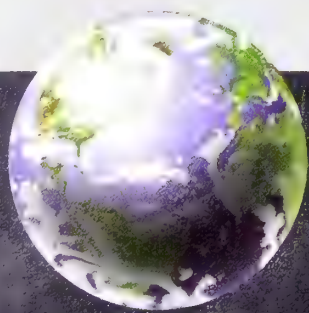
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FAILED WIZARDS OF WALL STREET

Can you devise surefire ways to beat the markets? The rocket scientists thought they could. Boy, were they ever wrong

Smart people aren't supposed to get into this kind of a mess. With two Nobel prize winners among its partners, Long-Term Capital Management L.P. was considered too clever to get caught in a market downturn. The Greenwich (Conn.) hedge fund nearly tripled the money of its wealthy investors between its inception in March, 1994, and the end of 1997. Its sophisticated arbitrage strategy was avowedly "market-neutral"—designed to make money whether prices were rising or falling. Indeed, until last spring its net asset value never fell more than 3% in a single month.

Then came the guns of August. Long-Term Capital's rocket science exploded on the launchpad. Its portfolio's value fell 44%, giving it a year-to-date decline of 52%. That's a loss of almost \$2 billion. "August has been very painful for all of us," Chief Executive John W. Meriwether, a legendary bond trader, said in a letter to investors. (Long-Term's executives declined to speak on the record.)

Long-Term Capital and its Nobel laureates in economics, Robert H. Merton and Myron S. Scholes, weren't the only ones who got creamed. Locating the losses is hard because

Wall Street and the hedge-fund world don't disclose them. According to Andrew W. Lo, a finance professor at Massachusetts Institute of Technology who advises several so-called quant funds, as much as 20% of hedge funds, which control some \$295 billion, are quantitatively oriented.

LONG-TERM DAMAGE. The losses didn't stop there. Nearly every major investment house and bank in the U.S. and abroad has a group of highly paid rocket scientists in its proprietary trading department trying to beat the market with complex, computer-aided trading strategies. In an announcement on Sept. 2, Salomon Smith Barney Holdings disclosed that it had realized \$300 million in losses from fixed income and global arbitrage—five times its \$60 million in Russia-related credit losses. Then, on Sept. 9, Merrill Lynch & Co. announced that it had lost \$135 million from trading and said that the losses had hurt its own stock price.

August may go down as a watershed in the history of high-tech investing. That's because the losses suffered weren't just financial: The reputation of quantitative investing itself





WHY THE COMPUTER MODELS MISFIRED

LACK OF LIQUIDITY When a computer program pinpoints a profitable hedge, the assumption is that there will be a buyer on the other side of the transaction when the deal is settled. But the turmoil in Russia and Asia so unsettled the markets that buyers disappeared.

BREAKDOWN OF PATTERNS Usually, traders can hedge their bets by investing in many different geographical regions. But in recent weeks, the patterns have become desynchronized, so that a decline in one region would no longer be offset by a rise in another.

LIMITED APPLICATION Models that may be useful for countries with well-developed markets don't work well in smaller markets.

MISSING STREET SMARTS Many mathematical geniuses with little practical experience in the markets have been hired on Wall Street. "Black box" models put on autopilot, without review or input by seasoned traders, can fail.

POLITICAL RISK The models failed to assess realistically the risk that Russia would backslide so abruptly on the road to capitalism.



LONG-TERM CAPITAL MANAGEMENT
ONE EAST WEAVER ROAD
GREENWICH, CONNECTICUT 06860

JOHN MERIWETHER
CHIEF EXECUTIVE OFFICER

September 2, 1998

To Investors in the
Investment Vehicles of
Long-Term Capital Portfolio, L. P.

Re: Impact on Net Asset Value of August Market

Dear Investor:

As you are all too aware, events surrounding the collapse of the Russian economy in global markets have

NEW TACK? Nobel laureates and Long-Term Capital Management partners Scholes (left) and Merton couldn't staunch the firm's losses in August

has been dealt long-term damage. Merton and Scholes, after all, are two of the most esteemed figures in finance—co-inventors with the late Fischer Black of the options-pricing model that underpins much of rocket science. They and their counterparts seemed to have developed a clean, rational way to earn high returns with little risk. Instead of betting which way a market is headed, they typically search for ingenious arbitrage plays—chances to cash in on temporary disparities in the prices of related assets.

Wall Street warmed to rocket science not because it was impressed with PhDs in physics or Nobel prize winners in economics. The Street was impressed by the money these quants were making without having to be a George Soros—placing informed bets on the direction of assets like gold, oil, or the British pound. The beauty of rocket science was that though the gambles were huge, the risks were minimal.

In August, though, many of these delicately constructed bets collapsed like a house of cards. Even if the quants do

spring back this autumn, it will be impossible for many of them to claim that they can reliably produce

low-volatility profits, because the volatility they've experienced this year is anything but low. Suddenly, many market-neutral funds aren't looking any safer than "directional" funds run by wizards like Soros.

To be sure, the performance of many quantitative hedge funds doesn't tar all of financial rocket science. Some quantitative firms don't use leverage and seek merely to outperform some benchmark such as the Standard & Poor's 500-stock index. By their own lights, many of those firms came through August fine—sinking, to be sure, but not as much as the benchmarks they measure themselves against. "Our first objective is to control risk," says Stephen A. Ross, a professor at MIT and co-head of Roll & Ross Asset Management Corp., whose return is up for the year and for the month of August against its benchmarks.

"NAUSEATING." That's fine for Roll & Ross, but the dark days of August weren't so kind to the quants that take bigger gambles in pursuit of bigger rewards. Turmoil enveloped almost every market. Real estate magnate Samuel Zell says that the market for commercial mortgage-backed securities, in which traders rely heavily on computer modeling, is in "meltdown." Invictus Partners, an eight-month-old arbitrage hedge fund, began June ranked among the top-performing hedge funds in the country, but then lost all of its gains over the summer—and more. "What began to happen in June, July, and August was hypnotic, nauseating,

and awesome," says Gregory van Kipnis, the fund's founder and CEO.

One prominent victim was the High Risk Opportunities Fund, a bond-arbitrage hedge fund. It was put into liquidation in the Cayman Islands on Sept. 1. Its \$850 million in Russian investments went bad after Moscow suspended bond and currency trading on Aug. 14. As befits a hedge fund of its type, High Risk Opportunities wasn't betting for or against the Russian economy—it was simply playing the 4% spread between the ruble-denominated Russian Treasury bills, known as GKOs, and the lower cost of borrowing rubles from banks. This seemed a safe bet because it didn't depend on Russia forking over dollars. The fund manager—III Offshore Advisors—was blindsided twice. First, the Russians halted trading in their domestic government debt market. "Nobody in the history of the world has ever done anything this foolish," says Warren B. Mosler, the firm's West Palm Beach (Fla.)-based director of economic analysis. Then, several European banks that had sold currency hedges against the plunging ruble abruptly suspended an estimated \$400 million in payments that Mosler contends the hedge fund is owed.

History is what underlies most of the quant models—however, it is not the history of governments, but of markets and prices. Their models are based on identifying historical relationships between the prices of kindred assets, be they bonds, stocks, or currencies. Mountains of data that reflect decades of market behavior are fed into computers. The computer models sift through the data to find the precise relationships between the prices of these assets. Sometimes, the prices move in the same direction. At other times, they diverge. When the assets move out of their normal alignment, the bell rings.

That's a signal to trade on the expectation that prices will revert to historic patterns. The trades can focus on markets throughout the world. It can be two related U.S. stocks, a basket of 15 U.S. biotechnology stocks, two Italian bonds of different maturities, or a basket of foreign currencies. But

A veteran trader Meriwether says his skills have been put to the test. "I did not anticipate how severe the test would be," he wrote clients

MERIWETHER FEATURED ON THE COVER OF BUSINESS WEEK'S AUG. 29, 1998, ISSUE

Cover Story

Unfortunately, Long-Term Capital Portfolio ("Fund") has also experienced a sharp decline in net asset value. As you know our formal procedure for releasing our official net asset value normally takes about ten days after month-end. Following our usual practice to give you an early estimate of the Fund's performance, it is down 44 percent for the month of August, and 52 percent for the year-to-date. Losses of this magnitude are a shock to us as they surely are to you, especially in light of the historical volatility of the Fund. The losses arising from the event-driven major increase in volatility and the flight to liquidity were magnified by the time of year when markets were seasonally thin.

across our Greenwich, London, and Tokyo offices during this extreme period. August has been very painful for all of us, but I believe that as a consequence, LTCM will emerge a stronger and better firm.

Sincerely,

John W. Meriwether

It's not always where the bet ends. In order to minimize risk, the computer then spits out what other trades could be made to hedge against any accompanying risks at the arb doesn't want to take on.

Normally, the price discrepancies that the models seek to exploit are tiny—and indeed, have become smaller and smaller as more and more players comb the markets. The result has been bigger and bigger bets. The computer model predicts the exact price points at which to enter the deal and the size of the bet to get the highest returns with an acceptable level of risk. This had led to the use of more and more borrowed money, resulting in many trades leveraged to the hilt. Hedge funds with mathematically driven strategies may be far higher than average leverage because of the perceived lower level of risk inherent in their using a large number of diversified positions," says George Van of fund-acker Van Hedge Fund Advisors International.

Why did rocket science backfire? Sure, the models do take into consideration the possibilities of some failures occurring in the market system that upset normal historical relationships. Indeed, that's why these bets usually involve a series of hedges. What occurred, however, was the financial world's equivalent of a "perfect storm"—everything went wrong at once. Interest rates moved the wrong way, stocks and bond prices that were supposed to converge diverged, and liquidity dried up in some crucial markets. As Long-Term's Meriwether told his shareholders in a Sept. 3 letter:

"We expected that sooner or later... we as a firm would be tested. I did not anticipate, however, how severe the test could be."

At the heart of the breakdown was a global "flight to quality" that was far more intense than the wizards' computer models predicted. They had been forecasting that differences in the interest rates of safe securities and risky ones, which had widened, would return to their normal range, as they almost always had before. But as Russia unraveled and parts of Asia fell deeper into crisis, investors around the world

switched their money into the safest securities they could find, such as U.S. Treasury bonds.

Many of the quant firms were betting on riskier, less liquid securities such as junk bonds, and they got crushed. Instead of narrowing, the spreads between safe and risky securities widened drastically in virtually every market around the world.

The unexpected widening of spreads wreaked havoc on supposedly low-risk portfolios. For example, some quant firms were betting that junk-bond yields in Britain had gotten too high in relation to those of high-grade corporate bonds, and that the spread would narrow. If the yield spread had narrowed, as forecast, the quants would have earned a bundle. But that's not what happened: The yield spreads widened and the quants owed a ton of money.

To work, the quant models need liquid markets on all sides of the trade. But markets in August are thin, as Meriwether noted in his letter to fundholders. Wrote Meriwether: "...volatility and the flight to liquidity were magnified by the time of year when markets were seasonally thin." That's the trouble with liquidity: It's never there when you really need it, as buyers of so-called portfolio insurance discovered in the 1987 stock market crash.

A liquidity drought is basically panic in slow motion. "It wasn't just the big hedge funds," says D. Sykes Wilford, a managing director of New York-based CDC Investment Management Corp. "This summer, it affected lots of people, particularly investment banks, banks, fund managers. They had to reduce their capital exposures. When they do that, other trades that may have looked smart all of a sudden were subjected to this liquidity shock, too, and it fed on itself."

WORLDWIDE PHENOMENON. The stinger is that liquidity dried up across markets. It was a worldwide phenomenon, so the geographic diversification employed by so many quant firms did them not a whit of good. Late August was actually worse for some market-neutral arbitrageurs than the 1987 crash, admit some quants. "They weren't all bullish and they weren't all bearish, but they were all believers in the liquidity and continuity of markets," says James Grant, editor of *Grant's Interest Rate Observer*.

The carnage was widespread because so many people were making the same kinds of bets. "When Russia announced default, everybody's risk appetite went down dramatically. Every position held on every dealer's books was subject to liquidation. Any concept of long-term or fundamental value disappeared," says William T. Winters Jr., head of Europe fixed income at J.P. Morgan & Co. in London. "Large in-



INVICTUS PARTNERS, LLC

Dear Investor:

In our last letter

July saw a continuation of the breakdown in market structure (coherence) we so critically depend on for profitability.

Whereas last month we could say: "In a statistical sense, based on our own daily data history, nothing highly unusual occurred in June." This month we must say that something highly unusual is happening. In my experience, that "something" has not been seen since the late summer/early fall of 1987, when the market underwent a dramatic breakdown in coherence well before the market break of October 19, 1987.

ARB HORROR: *Invictus' founder called the summer's losses "hypnotic, nauseating, and awesome"*

vestors lost money on positions that became very illiquid and volatile."

Worst hurt of all were highly leveraged hedge funds. Heavy borrowing amplified their returns on the way up, and it amplified their losses on the way down. When spreads widened in a disorganized, tumbling market, gains on short positions weren't enough to offset losses on long ones. Lenders demanded more collateral, forcing the funds either to abandon the arbitrage plays or to raise money for the margin

Cover Story

calls by selling other holdings at fire sale prices. Long-Term Capital responded to the crisis by shedding marginal deals, such as bets on the direction of interest rates, at losses, while keeping in place its core arbitrage bets. As its moniker suggests, the firm is able to hang tough longer than most hedge firms because its capital base is stable. The first date any investors can withdraw capital is the end of 1998, and even then the potential withdrawal is less than 12% of the fund. Borrowing arrangements are long-term as well—generally for six months or a year.

HUBRIS. If markets quickly return to their old alignments, Long-Term Capital will come out way ahead, and August will be nothing but a scary memory. Indeed, the firm is beefing up its bets by raising more capital from investors. But what if the spreads just keep getting wider? It could happen. Grant, the newsletter editor, likes to quote a play-it-safe Wall Street maxim: "Never meet a margin call." In other words, if the market is going against you, concede defeat

quickly and liquidate before you really lose your shirt.

Since the quants came to Wall Street, there has been no shortage of critics. Rocket science can't substitute for common sense, says Wilford, who manages a "market-neutral" hedge fund himself. "I've seen too, too many of these quant geniuses that don't have a clue about how markets behave. When they get a shock like this, they're dumbfounded. They just don't have the intuition of what to do."

The quants may have placed too much faith in their exquisitely tuned computer models. "The hubris of a bad quant can exhibit is, he thinks he has the best model of all time," says van Kipnis. "Many of these models provide the illusion of certainty," says economist Henry Kaufman of Kaufman & Kubarych. "There is a kind of assurance that ultimately cannot be satisfied."

In a certain sense, maybe the problem wasn't too much rocket science, but too little. Extreme, synchronized rise and falls in financial markets occur infrequently—but they do occur. The problem with the models is that they did not assign a high enough chance of occurrence to the scenario in which many things go wrong at the same time—the "perfect storm" scenario. Sources say Long-Term Capital's worst-case scenario was only about 60% as bad as the one that actually occurred.

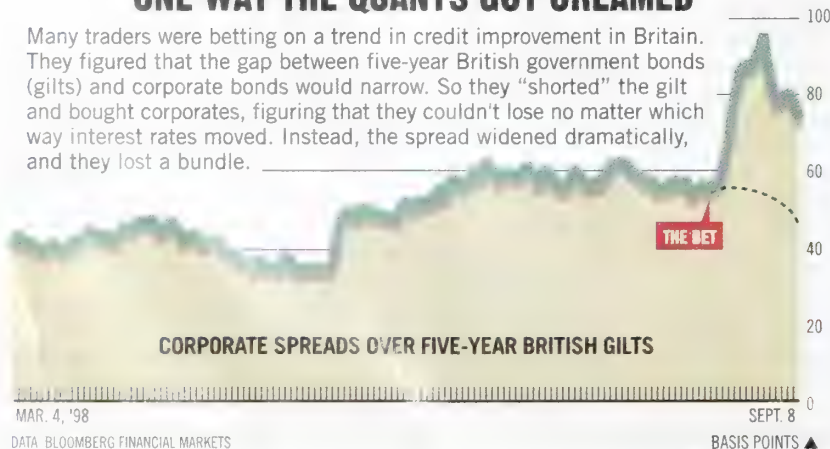
On the other hand, some quant firms made out just fine. Unlike Long-Term Capital, which looked at markets around the world, these firms are niche players, and their models concentrate on specific markets. Roll & Ross, for example, employs a value approach to stocks, using the latest academic research to screen for a combination of low price-earnings and market-to-book-value ratios.

Another example of wizardry that worked is a little-known niche firm based in Radnor, Pa., owned by Banque Nationale de Paris, called BNP/Cooper Neff Inc. The only bet BNP/Cooper Neff makes is arbitrage between stocks that become overvalued or undervalued because of such things as money flows in and out of markets. It is scrupulously neutral on the attractiveness of growth stocks vs. cyclical stocks, or large-capitalization stocks vs. small-cap stocks.

Although the firm's assets under management aren't huge—about \$10 billion—it estimates that it accounts for about 4% of the daily trading volume on the New York Stock Exchange and 6% t

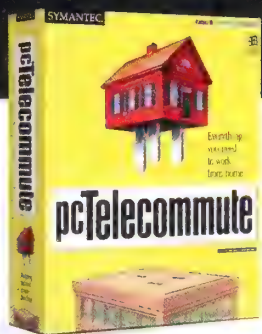
ONE WAY THE QUANTS GOT CREAMED

Many traders were betting on a trend in credit improvement in Britain. They figured that the gap between five-year British government bonds (gilts) and corporate bonds would narrow. So they "shorted" the gilt and bought corporates, figuring that they couldn't lose no matter which way interest rates moved. Instead, the spread widened dramatically, and they lost a bundle.





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10% of the volume on the principal exchanges of France, Germany, Spain, and Italy. BNP/Cooper Neff—which is so far not open to outside investors—needs enormous volumes of trades because its average profit margin per trade is so small. Their research staff includes about a

Cover Story

dozen physics PhDs. While it won't release its results, Chairman and co-founder Richard W. Cooper says: "August was the best month in our history. In markets that become irra-

tional, you can find greater mispricing opportunities."

But Cooper's firm is not typical. And, after its summer setback, rocket science, whether quants bounce back or not will be forced to change. It will have to adjust its models to account for more riskiness in global markets. The search for inefficiencies in markets that can produce profits will continue. But there's one thing to remember about being on the cutting edge: Sometimes, you bleed.

By Peter Coy and Suzanne Woolley, with Leah Nathans Spiro and William Glasgall in New York and bureau reports

COMMENTARY

By Gary Weiss

WHEN COMPUTER MODELS SLIP ON THE RUNWAY

The wreckage is everywhere as hedge funds, banks, and securities firms rack up big losses. This time, the losses are not sustained by free-wheeling high-rollers betting with their gut, but by nerdy computer mavens betting with their supercomputers and software—and losing. Despite state-of-the-art arbitrage trading strategies, virtual reality has failed to come to their rescue. Market-neutral strategies, in large measure, have failed. Their strategies may have been perfect on paper. But the market refused to cooperate.

The only surprising thing about the recent spate of high-tech trading failures is that they have come as a surprise to so many—even to some of the super-traders running these firms. Today, it is John W. Meriwether's Long-Term Capital Management. But in 1997, it was UBS and Natwest Capital Markets. And a few years before that, it was Askin Capital Management. The list goes on and on—a largely forgotten litany of disappointments (table).

BIG FLOPS. Trading models work well most of the time. But we should never forget that they are prone to calamitous failure. There's even a term of art for this phenomenon: model risk. Indeed, perhaps the most important lesson to be drawn from the recent blunders of some of the smartest people on Wall Street is that, sooner or later, some of their most promising models are bound to fail—and fail big. And there's not much that can be done about it.

Model failure can be a simple case of bad pricing data—"garbage in, garbage out"—such as the mispricing that touched off the collapse of David Askin's \$600 million hedge-fund fami-

ly in 1994. Or it could be the apparent cause of Long-Term Capital's sickening 44% decline in August, as its computer models became overwhelmed by an unexpected combination of market forces.

Whatever the reason, the latest travails give an illustration of what some observers have been saying for a long time. Quite simply, these models can be too complex for their own good. They are akin to an aircraft

"Controlling Model Risk." It contained a jarringly prescient exposition on the problems lurking in multifaceted computer models.

"Riskier derivatives often include very high degrees of leverage, exotic cash-flow patterns or are based on obscure markets," derivatives consultant Tanya Styblo Beder said in the October, 1994, issue of *Corporate Cashflow Magazine*. Valuing such derivatives, she noted, often depends

"on sophisticated mathematical models, creating the risk that the model's value may be different than that ultimately obtained in the market."

HARSH TEST. Even a master of the model universe such as John Meriwether seems to have forgotten that his financial strategies are far from unsinkable. In a Sept. 2 letter to investors, Meriwether pointed to the fund's record of stellar performance and noted that while he anticipated a setback, "I did not anticipate, however, how severe the test would be."

After explaining the fund's dreadful recent performance, Meriwether noted that the fund was giving its investors the opportunity to put in more money. A sucker bet? Not necessarily. The opportunities for

hefty profits, which sustained Long-Term Capital and other rocket scientists in recent years, have certainly not gone away. But Meriwether, and the rest of us, have been taught yet another lesson in the drawbacks of these delicately choreographed high-tech trading strategies. They're an alluring way of making money, no question about it. And they will continue to be—until the next disaster strikes.

Senior Writer Weiss covers the Street.

A ROGUE'S GALLERY OF FAILURES

ASKIN CAPITAL MANAGEMENT (1994) — A \$600 million hedge-fund empire collapses, a multifaceted calamity that was touched off by inaccurate valuations fed into a model used to trade mortgage-backed securities

BANK OF TOKYO-MITSUBISHI (1997) — Records \$83 million in derivatives losses from errors in one of its derivatives models

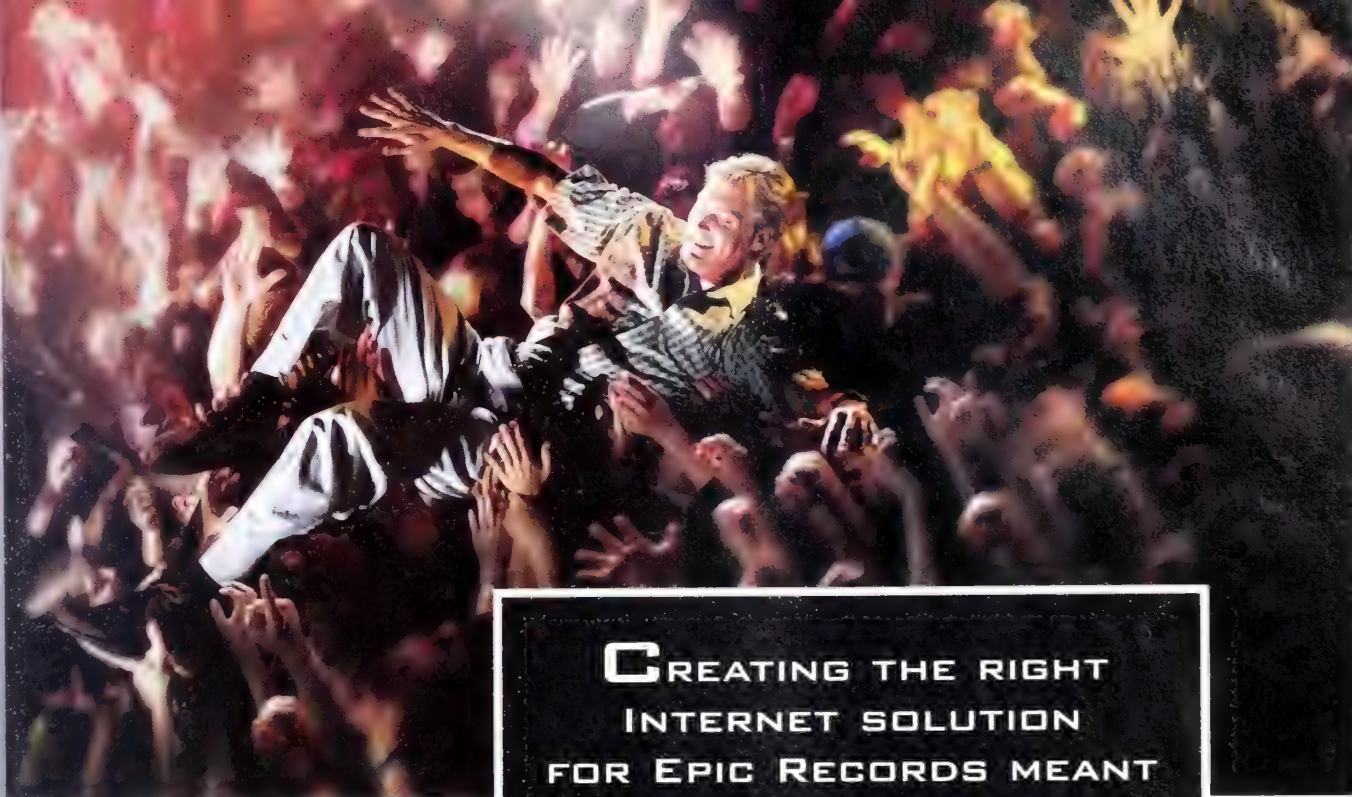
NATWEST CAPITAL MARKETS (1997) — Takes a \$112 million hit from mispricing a portfolio of German and British interest rate options

UBS (1997) — Huge Swiss bank loses \$412 million from derivatives, partly because of bad prices fed into an equity derivatives pricing model

DATA BUSINESS WEEK

engine breaking down because it inhaled a seagull. "Every model is based on all sorts of assumptions, and one of hundreds of assumptions in sophisticated models can go wrong. It gives people a false sense of security," notes Joe Kolman, editor of *Derivatives Strategy*, a New York-based newsletter.

Derivatives experts such as Kolman have been offering warnings about the dangers of model risk for years. Long before the latest crisis, *Derivatives Strategy* ran as its June, 1997, cover story, an article entitled



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U S W E B

BY GENE G. MARCIAL

IS EAGLE HARDWARE SET FOR SPLICING?

Alan Rifkin, Piper Jaffray's ace picker of retailing stocks, wasn't content merely to keep his buy recommendation on Eagle Hardware & Garden (EAGL): He upgraded his rating in mid-summer to a "strong buy." What's so alluring about this supplier of do-it-yourself home-improvement products?

For one thing, business in Eagle's markets, mainly in the Northwest, has picked up sharply, partly because of a buoyant housing market. And its stock has become "very undervalued," says Rifkin, compared with rivals. Also, Rifkin thinks that, in light of the current consolidation going on in the \$150 billion industry, Eagle will end up in the arms of Lowe's, second in size only to Home Depot.

"It's incumbent upon Lowe's to acquire Eagle," says Rifkin, so it can grow faster and move from conventional-size stores to a "chain of superstores on a national scale." Lowe's, with 461 stores in 26 states, mainly in the East, has publicly stated that it wants to reach 600 stores in two years and expand into California, says Rifkin. There's no overlap in the two chains' regions, says the analyst. Eagle plans to open six stores this year and a further 10 in 1999.

Rifkin figures that Eagle stock, now at 21 a share, is cheap: Eagle's price-earnings ratio of 18.9 compares favorably with 26 for Lowe's and nearly 40 for Home Depot, based on estimated 1999 earnings. In a buyout, Rifkin says Eagle could be worth 40, or \$1.1 billion—about the same as its estimated fiscal 1999 revenues. If Lowe's were to buy Eagle for stock, the deal would not dilute Lowe's earnings, says the analyst. Combined, Lowe's and Eagle would have total revenues of \$13.5 billion in 1998 and \$16.3 billion in 1999. Lowe's spokesman Brian Peace declined to comment on acquisition plans but said the

company aims to spend \$1.5 billion to build 100 stores in the West in a couple of years. Eagle couldn't be reached for comment.

MAKING A RUSH FOR SUGEN

Sugen (SUGN) is attracting fresh attention: With its stock at 11, down from 21 last October, this biotech company may be ready for new deals with strategic partners that may be eager to increase their stake in the company.

Sugen is striving to produce anti-angiogenesis agents, which cut off the flow of blood to a tumor. Research has focused on two fronts: It's seeking the oncogene behind certain cancers and developing compounds to fight it, and it's also trying to produce antiangiogenesis agents. In mid-July, it initiated phase-II trials with its lead product, SU101, for ovarian cancer, complementing trials of the same product for brain and prostate cancer. "The trials have shown some positive surprises," says Peter Hirsch, Sugan Executive Vice-President for drug R&D. By yearend, he says, Sugan will launch trials for a yet-unnamed compound that blocks the formation of blood vessels and simultaneously directly attacks cancerous tumors.

James McCamat, editor of *Medical Technology Stock Letter*, notes that SU101 is a small molecule that blocks the pathway regulated by one of the main oncogenes in brain, prostate, and ovarian tumors. To help develop anticancer compounds, Sugan has signed a pact with Britain's giant drugmaker Zeneca Group, which has acquired a 20% stake in Sugan, and also with Allergan, ASTA Medical, and Japan's Taiho Pharmaceutical. Except for Taiho, these companies have taken equity stakes in Sugan, and "they are all potential acquirers of Sugan," says Michael Kicera, president of MRK Capital Management, which has accumulated Sugan shares.

He expects Zeneca will buy more Sugan shares this year. It had acquired its stake at higher prices, and Kicera be-

lieves Zeneca will take advantage of the stock's decline and add to its position. He expects Taiho to buy shares as well. "The stock will jump on any good news about the trials," says Kicera.

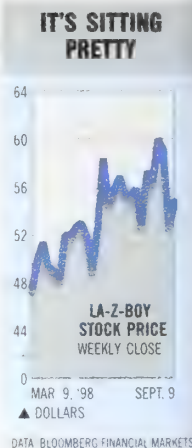
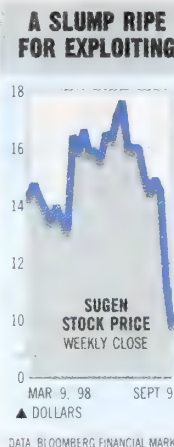
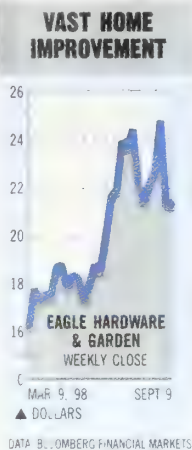
SOLID COMFORT AT LA-Z-BOY

Since the market's plunge, not many stocks are trading anywhere near their highs. One stock that has held up is La-Z-Boy (LZB), widely known for its reclining upholstered chairs. "The reason is nothing more than increasingly positive fundamentals," says Elliott Schlang of Lynch, Jones & Ryan, a Cleveland investment firm.

With yearly earnings growth of about 14%, La-Z-Boy "is a safe haven in an uncertain economy," says Schlang, who notes that sales have increased for 17 consecutive years and that earnings have grown in each of the past seven. And those averse to overseas exposure can relax with La-Z-Boy: 93% of sales are domestic.

With a 35% share in the recliner market, La-Z-Boy boasts better brand-name recognition among consumers than—believe it or not—Sony, Microsoft, or Polo Ralph Lauren, at least according to a study conducted by Household Furniture Network.

But La-Z-Boy has yet to capture a wide following among institutional investors. So the stock trades at a low p-e ratio. Now at 56 a share (equivalent to 18 after a 3-for-1 split takes effect on Sept. 15), the stock is trading at just 15 times estimated 1999 earnings of \$1.14 a share, and 14 times 2000 earnings of \$1.28. Schlang believes La-Z-Boy is a sleeper: He reckons it will kick up to 30 this year. A strong housing market and buoyant consumer confidence could, he says, produce positive earnings surprises in the next couple of quarters and boost the stock.



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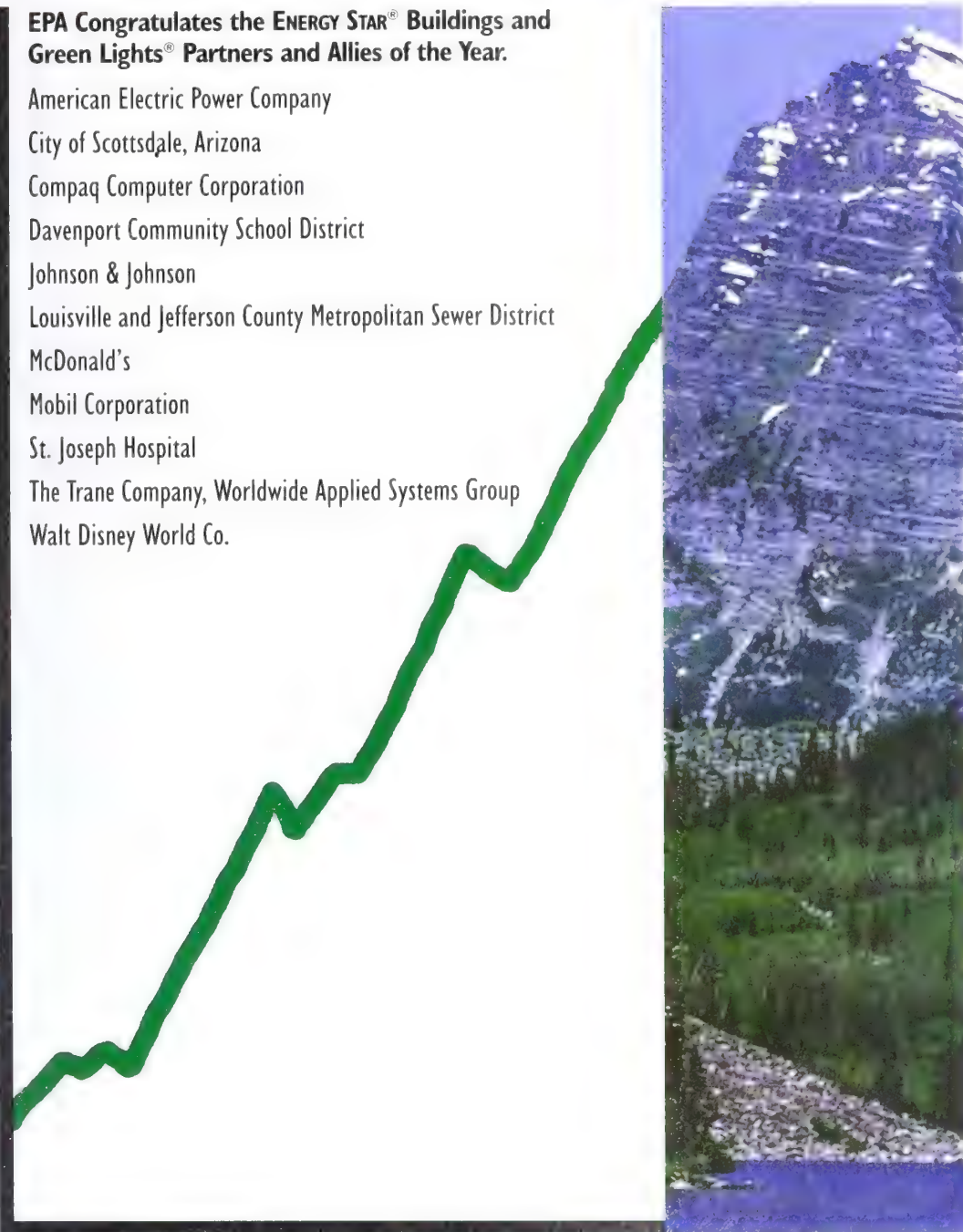
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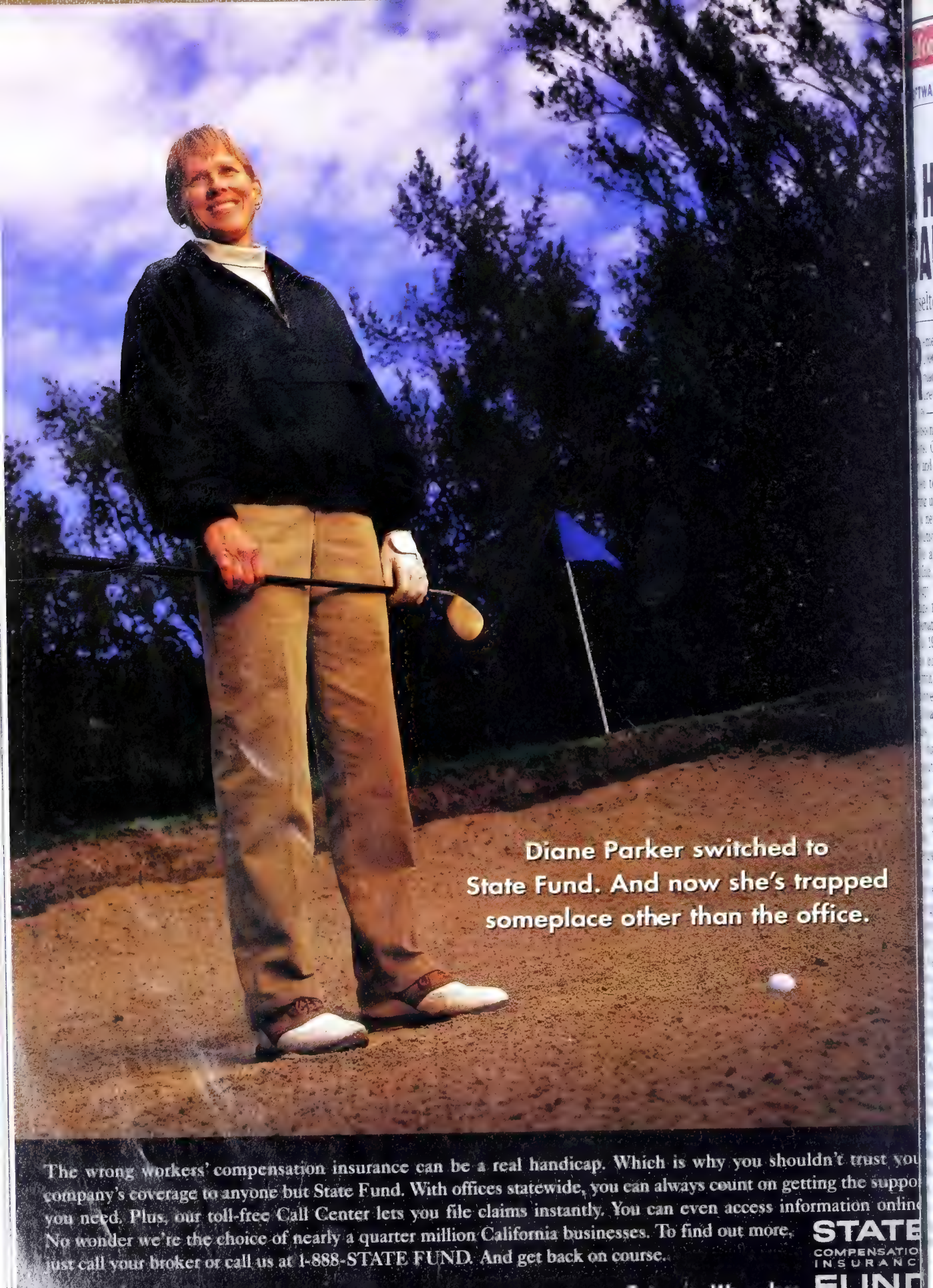
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A HOLLYWOOD STAR CALLED... NEWTEK?

anseltown's leading supplier of animation software is gearing up for HDTV

Remember the Video Toaster? In 1990, the funky Amiga PC add-on made it possible for a novice to create, animate, and edit video on a PC—launching a video revolution in television animation and movie special effects. Creator Tim Jenison's plug-in and graphics software received television studio gear worth up to \$100,000, unleashing a new wave of Hollywood innovation.

For a time, Jenison's NewTek Inc. was the toast of technology startups. But when Amiga PC maker Commodore International Ltd. went belly-up in 1994, Jenison's San Antonio company nearly burned with it, forcing the 43-year-old inventor back to the drawing board. For the past four years, NewTek has survived by churning out innovative computer graphics software, which has helped to craft everything from fireball-spewing dragons on television's *Na: Warrior Princess* to the intergalactic spaceships in the movie *Lost in Space*. NewTek's lightweight 3D software was among the technologies used to simulate the Titanic in the recent hit movie. Margot Pip-er, head of TV animation production for DreamWorks SKG, says Jenison's software is "taking over Hollywood." NewTek expects to be modestly profitable this year, on revenues of 7 million.

But for Jenison, NewTek's comeback is just beginning. Whether it can regain its past glory will depend mostly on the success of Jenison's newest invention, now nearing completion: a Video Toaster for the era of high-definition TV—technology that will let programmers and animators produce

standard, digital, and HDTV content on a Windows PC. Says Jenison: "Our goal is to leapfrog the competition and create another upheaval like the Video Toaster created."

High sights for a guy who grew up without a television. Indeed, Jenison

credits his parents' strict ban on TV—and movie-watching for his fascination with moving images and technology and for his desire to bring video technology down to the farm for anyone with access to a personal computer.

Raised in rural Iowa, Jenison was a brilliant if nerdy kid, the son of strict Lutherans "who thought TV was a bad idea," he says. While other kids were watching *Leave it To Beaver*, Jenison was at his father's workbench, devising mechanical and electrical wonders. Those inventions often had a direct application, even then: In grammar school, Jenison rigged up an electric cord and battery pack to deliver a 10,000-volt jolt to a school bully.

Still a bit of a nerd in high school, Jenison learned to write software by reading IBM manuals and later picked up chip engineering from textbooks. Jenison also developed an interest in moviemaking and in the kind of TV sets he never had as a kid. Jenison now boasts a collection of 300 antique sets, including a rare 1959 Philco Predicta Danish Modern, now on display at NewTek's headquarters. "My career motivation was to make a real TV show," Jenison says. "I was just a frustrated filmmaker."

HOLY GRAIL It all came together for the entrepreneur in the 1980s, when he discovered the Amiga and its unique ability to generate a standard television image. He found personal computers the perfect outlet for cutting the costs of TV production equipment, thereby allowing ordinary people to produce their own shows.

But Jenison's greatest challenge lies ahead. Recreating the Video Toaster for HDTV will re-



TIM JENISON

BORN Mar. 21, 1955, in Belmond, Iowa

EDUCATION Belmond High School, 1973. Physics major for one year at Iowa State University

FAMILY Wife, Leslie, three daughters

HOBBIES Collects old television sets, flies helicopters and airplanes, and plays jazz and blues piano. Owns three Cessna aircraft, including a 1947 Cessna 120. Currently rebuilding and converting a church pipe organ into a synthesizer

PEOPLE HE ADMIRES His father, Leland Jenison, Bill Gates, Thomas Edison, and Ayn Rand

WHY HE FOUNDED NEWTEK IN TOPEKA, KAN. "I met a girl and never achieved escape velocity"

quire nothing less than discovering the Holy Grail of computer filmmaking—a low-cost way to produce and distribute live video for standard, digital, and high-definition television. Creating and editing such video means devising a system able to handle the digital equivalent of three CDs a second. That equipment now costs upwards of \$500,000. But Jenison's goal is to make such a device as affordable as the \$2,500 Video Toaster was in its heyday. "If Tim can do that, he'll have a real hit on his hands," says Charles A. Pantuso, head of HD Vision Inc., an Irving (Tex.) high-definition video production house familiar with NewTek's work.

Besides the technical challenges, Jenison is facing other hurdles. His forte is inventing, not managing. "Tim's a good engineer, not a good CEO. He's afraid to give up control," says NewTek co-founder Paul Montgomery, now co-CEO of rival Play Inc. NewTek loyalists hope Jenison's search to replace former chief executive Dwight Parscale, who left NewTek last March and recently joined rival Electric Image, will help keep Jenison on track.

LOYAL LEGIONS. Another challenge for Jenison: money. The company has plans to finance the launch and dealer training for NewTek's next-generation Video Toaster via a \$10 million private placement of stock.

Can he do it? Jenison has learned from his mistakes. Once a company exclusively focused on one product, NewTek has since broadened its offerings, with software for Web developers and a color-test generator for studio engineers. NewTek also has kept its army of filmmakers and animators loyal by developing 3-D software for Windows, Mac, and Unix computers. NewTek regularly supplies customers with software to achieve new effects. "Tim's always coming up with unusual ways to make things happen," says Ron Thornton, a friend who runs Foundation Imaging, a Valencia (Calif.) TV special-effects producer.

Case in point: Frankie, the Singing Duck, a toy Jenison invented three years ago that moves around the office emitting Frank Sinatra tunes. Jenison created the duck to test an idea he had to use MIDI—or musical instrument digital interface software—to operate motors that move its feet, beak, and blue eyes. That's the kind of zany creation that has made Jenison and his NewTek a Hollywood legend. Next stop: proving he can bring the same creative spunk and staying power to HDTV.

By Gary McWilliams in Houston



HIGH-TECH GUINEA PIG
Bob Vanech (left) tests Root's ability to keep up with entrepreneur's dizzying pace
9:45 As he and co-worker S. Lee dash from a meeting, Vanech puts in a call to Root.

COMPUTER SERVICES

FOR THE EXEC ON THE RUN, A DIGITAL VALET

Root aims to be everything from travel agent to help desk

Manhattan, Aug. 13, 10:15 a.m. Bob Vanech is racing through Central Park in a cab after a meeting with a prospective partner for his company. Vanech ignores the trees and the mid-morning joggers; the cab is whizzing past. Instead, he is focused on his handheld Palm III, coordinating his schedule via cell phone with Root, a service he is testing that acts as a Digital Age concierge or secretary. "O.K., so reservations for 1:15 at Blue Water Grill," Vanech says. "Great."

In the next five minutes, the Root employee on the other end of the phone advises Vanech that he should show up at the restaurant at 1 p.m. because he can probably get seated earlier. Vanech then O.K.'s a memory purchase for his computer that Root researched over the Internet and decides on accommodations Root found for a

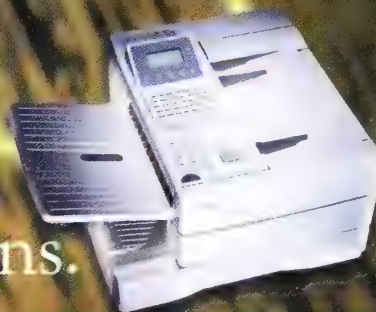
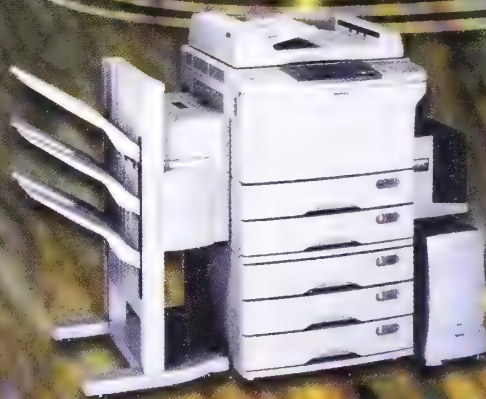
weekend getaway. Then it's over and out, as Vanech heads to his next meeting in midtown.

Meet Root, a new service that could be the answer for frazzled executives trying to sort out the Information Age tangle. Drowning in E-mail? At a loss over the complexity of your personal computer or how to get the most bang out of the Internet? Root.net Inc., New York startup, thinks it has the solution for on-the-go executives who don't have a personal assistant. "We're talking about people who have more money than time—the harried digital professional," says 28-year-old Seth Goldstein, who co-founded Root.net in March.

At its most basic, Root is a secretarial consultant, and technical adviser all wrapped into one. It offers the personal touch to those whose work and home lives have become

"We're talking about people who have more money than time"

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Most of the business leaders attending the 8th Annual Business Week Asia Leadership Forum held in Singapore are confident in Asia's long-term success, but they fear that recovery will be lengthy and that the worst is yet to come. Corporate stewardship and good governance will be essential ingredients in any recovery.

"The impact of globalization on the region has been immense, and some countries in the region are still in denial," said the **Honorable J. Stapleton Roy**, United States Ambassador to Indonesia. "Politically, the regional crisis has sparked a crisis of confidence in capitalism, which could have potentially dangerous consequences."

"Asia thought the party would never end. It did not learn temperance when the going was good," said **Dr. Noordin Sopiee**, chairman and CEO, Institute of Strategic and International Studies. Therein lies a lesson for developed countries. "Don't believe that the contagion won't catch up; governments must learn to be proactive rather than reactive," said **V. Shankar**, managing director, Investment Banking, Bank of America. Sopiee continued, "We now face an opportunity of historic proportions to make ourselves stronger, more competitive." **John Major**, former Prime Minister of the United Kingdom, asked, "Will there be a Pacific Century? Absolutely. Will we come out of it stronger? Absolutely."



Dr. Noordin Sopiee
chairman & ceo,
Institute of Strategic &
International Studies



V. Shankar
managing director,
Investment Banking,
Bank of America



Tanri Abeng
State Minister for
State Owned
Enterprises, Indonesia



Peter Gontha
vice-chairman,
Bimantara Citra

New Leaders, Big Problems

Tanri Abeng, Indonesia's State Minister for State Owned Enterprises, is positive about his country's political transformation. "I am optimistic about the future because of who our CEO is [President B.J. Habibie]. He understands the needs of the people. He understands that rice, not airplanes, is needed now." Indeed, he said, political prisoners have been released, unions are being allowed to form, and there are preparations under way for elections and new laws enshrining the separation of powers. Reforming

Indonesia's banking industry and transforming its state owned enterprises (SOEs) are top priorities that are also politically sensitive. Its bankruptcy laws were expected to be modernized by August. Next will be legal and judicial reforms in order to improve transparency. By all accounts, President Habibie is apparently listening to the private sector. A new Bill of Rights may help convince the ethnic Chinese it is safe to return. "The time is past for divisions based on race or religion," said **Peter Gontha**, vice-chairman, Bimantara Citra, Indonesia.

by Corie McDougall, research
associate with Intercedent Asia

BusinessWeek

McGraw-Hill Inc. 1998

8TH ANNUAL BUSINESS WEEK ASIA LEADERSHIP FORUM, SINGAPORE



Edgardo Espiritu
Secretary,
Department of
Finance, Philippines

Moreover, "Indonesia needs do more PR — we are still telling people what we're not, rather than what we are."

High Peyman, managing director, Dresdner Kleinwortson Securities agreed: credibility is the key, but it doesn't exist yet."

In contrast to Indonesia, the Philippines has enjoyed a relatively peaceful political position. **Edgardo B. Espiritu**, Secretary of the Department of Finance, outlined the benefits. "There is already a high level of confidence in the country's political system, something which cannot be said of a number of other countries in the region. The cabinet of the Philippines' newly elected President, Joseph Estrada, is well regarded — a positive sign for the development of the country over the next few years. The difficulties faced in the Philippines in the mid-'80s have helped it to weather the recent crisis relatively well. As a latecomer to the region's rapid growth, the Philippines less affected by the crisis. It has had the advantage of learning from the mistakes of others."

Are Next Casualties?

Wayne Barnathan, Asia regional editor, Business Week, Hong Kong, warned that after Indonesia, China is the next most likely country to experi-



P. Chidambaram
member of parliament, former Minister of Finance, India

ence social unrest due to economic problems. The rise in unemployment resulting from the layoff of millions of SOE employees is a significant challenge facing the government. A sustained minimum growth level of 7%-to-8% of GDP will be required just to absorb the newly unemployed. On the positive side, stabilization of the region is in China's best interest as it undergoes an economic transition. Meanwhile, China is earning praise for helping the region to once again achieve equilibrium. It is also assuming a much stronger leadership role as its relationship with the United States matures.

Leadership is not a problem in China; the opposite is true of India where business remains shackled by numerous constraints. According to **The Hon. P. Chidambaram**, MP, India's former Minister of Finance, India seemingly "takes the longest possible route" in implementing policy changes. "India's business leaders need to stop demanding the protection of tariffs and recognize that India is not in danger of being taken over by foreign ownership." Words of advice to foreign investors looking at India came from **Anand Mahindra**, managing director, Mahindra & Mahindra. "Stop looking at



Anand Mahindra
managing director,
Mahindra & Mahindra



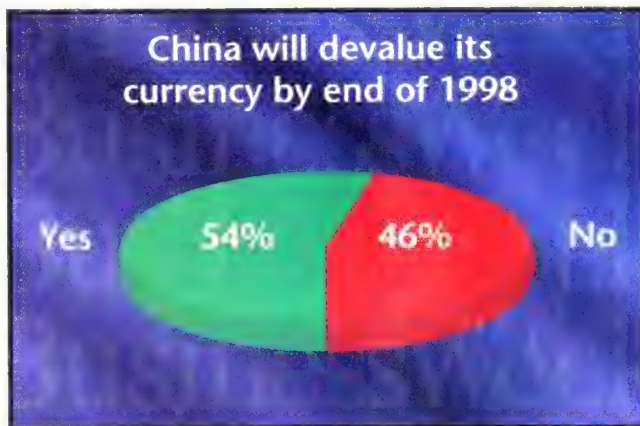
Peter Lau
chairman,
Giordano
International

Will China Devalue its Currency?

On the question of whether China will devalue its currency, several arguments support a continuation of the status quo — at least until 1999.

China's huge foreign reserves and the country's capital account should hold up even as the current account suffers due to competition from Southeast Asia. The last thing China

needs is a destabilized region and a competitive round of devaluations. Nonetheless, the value of the yen against the American dollar is critical. **Peter Lau**, chairman of Giordano International, Hong Kong, revealed that over the last nine months Giordano has shifted 60% of its China production to Southeast Asia: "How long can China live with this?"



Results of anonymous polling of 320 delegates at The Business Week Asia Leadership Forum. Each had access to a keypad and was able to answer questions asked during the Forum.



William Henderson
postmaster general,
United States
Postal Service

Going Global

William Henderson, postmaster general of the United States Postal Service, is responsible for the handling of 43% of the world's mail. Global Delivery Services, offered through the Postal Service's International Business Unit, provides a range of delivery and marketing consulting services to customers interested in "going global." The special emphasis on value-added customer service has proven to be an effective channel into international markets. The U.S. Postal Service, carried over one billion pieces of international mail in 1997 alone.

India as one country." Mahindra believes that the role leaders take in their individual states is key in the

development of their region.

N.R. Narayana Murthy, chairman and managing director of Infosys Technologies,

8TH ANNUAL BUSINESS WEEK ASIA LEADERSHIP FORUM, SINGAPORE



John Major
former Prime
Minister,
United Kingdom

Bullish on Asia

The former Prime Minister of the United Kingdom expressed faith in Asia's recovery from the current crisis. He declared, "I for one do not believe the Asian miracle will go away . . . Now is a good time to invest in Asia, while prices are low. The problem in Asia is a collapse of asset values, not a problem of competitiveness," said Major.

"Western investors should maintain a long-term view of the region. Capitalism is the right course for Asia, as it has been for countries such as Russia. Asia should keep in mind the adage: 'money is the root of all progress.'"



N.R. Narayana Murthy
chairman &
managing director,
Infosys Technologies

explained his company's secret to success in the dynamic software industry is a belief that "a plausible impossibility is better than a convincing possibility." In advocating the development of political democracy across Asia, and its accompanying upheavals and difficulties, Business Week's Asian edition editor Christopher Power proposed that "messiness should become an Asian value."

The New Asian Business Model

A transition is required for Asia's family-owned businesses. They are perceived by the market as higher risks and, as a result, will face higher capital costs. The crisis has been a wake-up call: The economic rules in Asia are no different from those in the rest of the



Colm McCarthy
executive vice-president and regional manager, Southeast Asia, Bank of America

world. Colm McCarthy, executive vice-president and regional manager, Southeast Asia, Bank of America, explained that the high growth in the region over the past several years worked to hide a number of inefficiencies — poor management being one of these. He predicted at the Forum that "the best practices from the rest of the world will now be coming to Asia."

"At the corporate level, the ability to manage financial risk has to be learned very quickly," said Erik Nickerson managing director, Risk Analysis, Bank of America. "In Asia, people don't manage risk, they trade it. Companies in Asia must quickly adapt to a new mentality of being responsible to shareholders. Similarly, the old axiom 'cash



Paul Latchem
chief executive officer,
Pharmaceutical & Food
Companies
Kalbe Farma Group

Case Study

Paul Latchem, chief executive officer, Pharmaceutical and Food Companies, Kalbe Farma Group Indonesia, shared his experiences in managing through the crisis. As a company whose earnings are in rupiah and expenses in dollars, Kalbe Farma has been hit severely by the currency devaluations. The market capitalization of the company, in U.S. dollar terms, has dropped from a value of \$800

million last year to \$15 million this year. Compounding Kalbe Farma's financial woes, the cost of servicing its dollar denominated debt has skyrocketed. Latchem explained that significant changes are being made within the family-owned company to focus on its core pharmaceutical business. The food and packaging components of the conglomerate are being divested. However, Indonesian regulations and licensing requirements have frustrated the company as it attempts to merge the eight subsidiaries that make up its pharmaceutical business. Kalbe Farma is focusing on its core business, which involves first examining its operations side. "We are concentrating our efforts on cleaning our P&L and on obtaining U.S. dollars and keeping them 'somewhere else.'" The company is in survival mode, and Latchem does not believe that Indonesia has "hit bottom" yet. Financing is crucial and a strong working relationship with one's creditors is important at a time when the entire banking system is in question. Kalbe Farma is looking to venture capital and multinational capital in its efforts to obtain the necessary financing to survive the crisis.



Kai-Uwe Seidenfuss
vice-president,
Strategic Planning and
Controlling,
Daimler-Benz Asia

Doing Business in Asia

Kai-Uwe Seidenfuss, vice-president, Strategic Planning and Controlling, Daimler-Benz Asia, emphasized the importance of the three cornerstones of corporate strategy: shareholder value, innovation, and globalization. In discussing innovation, Seidenfuss agreed with management guru Michael Porter's redefinition of a mature industry: "There are no mature industries, rather, there are mature ways of doing business." With 5,700 patent applications filed in one year, his company is clearly not content to simply maintain the status quo.

is king' must be adhered to. Better cash management, an improved balance sheet, and short-term profitability are essential at this time. Strategic

decisions must be made regarding each company's customer base — the survivors need to be identified and alliances structured.

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Philip Eng
group managing
director,
Cycle & Carriage
Group

Long-Term Player

Philip Eng, group managing director of the Cycle & Carriage Group, oversees one of Singapore's top 20 listed companies. Cycle & Carriage is a diversified group with core businesses in motor vehicles and property. The current economic crisis is affecting these industries significantly. In weathering this crisis, Eng maintains a long-term

outlook: "The Chinese phrase for 'crisis' consists of two characters, 'danger' and 'opportunity.' We recognize that in the current situation while there are problems, opportunities are also present. We need to focus our resources on core activities for business regeneration and value creation."

Industrialists say their basic strategy is a retreat to their core business. "It will take the region's banking sectors, which have been slow to reform, many years to recover. In the meantime, corporate bonds rather than loans or equity will be an important new avenue for raising funds. But this requires much higher standards in terms of transparency. **Daniel Huber**, president, Cargill Asia Pacific, emphasized shared responsibility. "Representatives from the top businesses in each country should get together with governments and work to solve the problems."

Scott Fraser, executive director, Deloitte & Touche Consulting Group/Braxton Associates, said the crisis is an event, but rather a process. Consequently, companies should take measures to adapt rather than endure. They must now focus on value creation, not simply on growth. Due to the misallocation of assets, wealth was being destroyed in Asia for a long time." The economic crisis behind the typically undiversified Asian con-

glomerate is collapsing. **Chua Jim Boon**, general manager of Hong Leong Management in Malaysia, recommended a back-to-basics approach, the "three R's — right size, right business, right funding." **Phillip Kelly**, president of Dell Computer Corp, Hong Kong, said, "Do not ask yourself 'how can you survive?' but rather 'how can you emerge a winner?'" Some key steps Kelly outlined toward achieving this include:

- Improving currency/foreign exchange management
- Developing customer relationships in order to build loyalty
- Open communication with the home office, board of directors, peers, etc.
- Strong internal leadership — essential in these tumultuous times

Exporting your way through the crisis is an option for some companies.

Markets

In explaining the crisis, **Cecile Saavedra**, managing director, Asia-Pacific Ratings, Standard & Poor's, Singapore, pointed to the "fundamental



Daniel Huber
president,
Cargill
Asia Pacific



Scott Fraser
executive director,
Deloitte & Touche
Consulting
Group/Braxton Associates



Phillip Kelly
president,
Dell Computer Corp

error" most countries in the region made in "not acting more quickly to cool their overheated economies." Rebuilding confidence will require the coordinated action of three areas: the sovereign sector, the financial institutions, and the corporate sector. **Chen Ean Wah**, chairman, Asia ex-Japan, Morgan Stanley Institutional Investment Management, Singapore, added that, "Economies in Asia must demonstrate their ability to compete globally." Shankar of Bank of America disagreed and claimed that, "the whole concept of rebuilding confidence is inappropriate," given

that the very nature of capital markets is to look for high risk and volatility. Shankar tempered this provocative statement with the admonishment that "the loosening of the capital markets should be accompanied by increased regulation and sophistication of regulation of these markets." Shankar went so far in his belief that more aggressive activity in the region should be encouraged that he declared, "We need to discover or create a Michael Milken in Asia." Furthering this argument was the general agreement that, at this time, Asian debt is more attractive than Asian equity.



Lim Toon
executive vice-
president,
Singapore Telecom

Asia Pacific Key Focus

Singapore Telecom is deeply committed to international expansion, and the Asia Pacific region remains a key part of these plans. **Lim Toon**, executive vice-president of Singapore Telecom responsible for International Services, is confident in the future — and it shows: Singapore Telecom has invested S\$1.9 billion in 49 joint ventures and strategic investments

in 19 countries including China, Indonesia, Thailand, Australia, Vietnam, and the Philippines. Commenting on SingTel's recent rate reductions, Lim Toon declared, "In light of the current economic environment, we believe our customers will certainly welcome such efforts to help them lower business costs. At the same time, lower rates will also ensure that Singapore Telecom remains competitive."

Information Technology

creasingly automated. "People want the efficiency they've learned to get from ATMs and computer screens, but on the other hand, it's reassuring to have the human element," says Baruch College Professor Leon Schiffman, who handled consumer focus groups for Root.

How will it work?

As the service begins signing up members this fall, customers will be able to contact Root via the Web, phone, or E-mail. Root employees then use every technology at hand—the phone, computers, the Net—to book hotel reservations and make last-minute changes in meeting schedules. They recommend and purchase technology products. And they help customers figure out which software to use.

But that's only if Root passes muster. Helping make that decision is Bob Vanech, busy executive and human guinea pig since July 15. Like the star of *The Truman Show*, a recent movie about a man whose life is watched by a TV audience, Vanech's every move is being monitored by Root during a five-week trial. In return, Root's seven-person company is at his disposal. That means Root is doing almost anything Vanech wants—so long as it doesn't entail picking up things: no laundry deliveries, no putting out the garbage.

DIGITAL DELUGE. Why Vanech? He's the classic on-the-go professional—technology-savvy, yet overwhelmed. After eight years in MCI Communications Corp.'s sales organization, the 29-year-old executive founded Silicon Alley Telecom, a New York-based company that wires commercial buildings for the Internet and other data communications. Today, Vanech uses E-mail, the Web, and voice mail. He has 12 phone numbers, including his two offices, home, and his portable phone. During his 1½ hour daily commute from Stamford, Conn., to New York, he works on his laptop. But he doesn't have time to spend learning new technologies, even if they could make him more productive.

As lucky member No. 1, Vanech has tested Root's boundaries. He had Root hunt for an apartment in New York, find visa information for a German visitor, and book travel, hotel, and restaurant reservations. At the beginning of



12:30 Meeting with Thorn Communications CEO Anthony Spina, Vanech makes use of the Palm III Root recommended

the trial, Root recommended Vanech buy the 3Com Corp. Palm III digital organizer he now carries everywhere. On some days, Vanech says, he has called the Root service 20 times in an hour. At other times, like the end of August when he was working on a business plan, he didn't use the service for days.

Vanech says the more he uses the service, the more comfortable he has become with it. At the beginning of August, he asked Root to buy him a PC. Root sent recommendations via E-mail.



2:30 Vanech puts in a call to Root to introduce client Debra Larsen, who is interested in the high-tech service

But Vanech worried the Root employees might not find the lowest price, so he went online to see if he could find something cheaper. He

found a bargain basement PC—but without the shipping and handling Root already had figured in. In the end, he bought the PC Root had recommended. "I feel confident with them now, and the nominal difference I might be able to find on things isn't worth my time," Vanech says.

It's this kind of trust that Root is counting on. To give the velvet-glove treatment, the service keeps a digital

record of how each task is handled. That info is put in a database so that when the next request comes up, employees are in the know.

It's no surprise that the idea for Root was hit upon by some go-go Web entrepreneurs who had done a lot of gadget- and data-juggling themselves. Goldstein and co-founder Dan Stoller are novices to technology—nor to the feeling of being deluged by it. In September, 1995, Goldstein started SiteSpecific, a New York-based Web ad-placement service, and hired Stoller to work with him.

After the startup was sold to ad agency CH Group last year, Goldstein cooked up Root, a name chosen because "root access" means you have complete control over a computer system. Since founding Root.net, Goldstein, Stoller, and other investors have poured about \$200,000 into the project. The goal now is to raise about \$2 million in outside funding. "It's not a sure bet," he admits, "but I did it because I wanted to belong to a service like this."

A lot is still up in the air. At the early stage, pricing estimates for the service include a \$250 to \$750 initiation fee, a \$200 to \$400 monthly fee, and a service charge of about 5% to 10% per transaction. Goldstein compares those prices, which could amount to an average of \$10,000 to \$15,000 a year for a heavy user, to the \$40,000 an executive would pay a secretary annually. For Root.net, the key is figuring out how to be cost effective—automating common requests and getting relationships with merchants, like TicketMaster, to share costs. "The idea is easy. The implementation will be a challenge," says Esther Dyson, chairman of New York-based Adventure Holdings Inc. Still, Dyson is a fan of Root.

Within a year, Goldstein expects Root to have 5,000 paying customers. When the service will look like in six months is hard to predict. Those who have seen the project, such as Dyson, are excited about it. That's the typical reaction, says Goldstein. "But they also always say 'Get back to me when you've figured this out.'" So it's back to *The Truman Show*.

By Heather Green in New York



CHURNING MUD:
*Regina Maersk
nears New York*

their contracts at the Port Authority of New York & New Jersey set to expire, two of the world's biggest container shippers—Sea-Land Services Inc. and Maersk Inc.—are seeking an East Coast port that can host the big ships. Roads and rails would then be used to deliver goods through-

out the Northeast and Midwest.

Sea-Land and Maersk, which account for 20% of the global market and 25% of the traffic in New York Harbor, have set off a bidding war between New York and ports from Halifax, Nova Scotia, to Norfolk, Va., each of which is trying to offer a better-equipped port.

The stakes are enormous—not just for the East Coast but for the shipping industry worldwide. With booming exports expected to lead to a surge in North Atlantic maritime traffic from Europe and Southeast Asia, bagging Sea-Land and Maersk would cement the winning port's position as the premiere North Atlantic hub.

DREADED DREDGING. "We're looking at a port that's going to accommodate us for the next 45 to 50 years. . . . If we come up with the right economics, we're going to move," says Anthony A. Scioscia, Sea-Land's senior vice-president for North American operations.

A downside for the winning port is that it will have to take the costly and environmentally sensitive step of dredging its channels for the new ships. Therein lies New York's problem. New York Harbor has a natural depth of 18 feet, but its channels and ports have been dredged to 40 feet—down to the bedrock. Going any deeper requires

blasting away at the harbor floor with explosives.

In 1986, Congress authorized dredging to deepen the New York channel. The Army Corps of Engineers is set to begin the dredging this winter, in a project that will cost \$732 million and take five to nine years to complete. When it is finished, the harbor's channels will be 45 feet deep—still too shallow for the likes of the Regina, which will require a 50-foot draw.

When Congress authorized the dredging 12 years ago, no one could guess that container ships would require such depths. By the time the studies, permits, and funding for the dredging were in place, the project had already become obsolete. With at least a 10-year lead time on any dredging project, the corps is now fast-tracking a study to determine whether it can take some New York Harbor channels to 50 feet.

Yet another problem for New York is what to do with all that dredged material, which is salted with toxins that must be treated before it can be dumped on land or used as construction fill.

Compare that to the climate at the Port of Virginia in Norfolk, the top contender for Sea-Land and Maersk's business. The main channels are already 50 feet deep, and berthside dredging is in the works. Rail comes right into the terminal, which is undergoing a \$400 million expansion and already has the big cranes needed to unload big ships.

The carriers' decision is expected this fall. If they pull up stakes, the Northeast might see higher prices for consumer goods because they likely will be brought in from a distant hub port by truck or rail. Jobs could be affected, too. The New York-New Jersey port pumps \$20 billion a year into the regional economy, creating, directly and indirectly, 180,000 jobs.

In the meantime, carriers have already begun diverting some of their business north to the deeper waters of Halifax. That could be a sign of bigger things to come.

By Lorraine Woellert in Washington

SHIPPING

SEEKING A DEEP HARBOR

Ports are racing to satisfy the needs of new megaships

When the gleaming, blue Regina Maersk—her deck the size of three football fields—sailed into New York Harbor in July, a crowd gathered to see the megaship, one of a new class of giant cargo vessels. But the welcome was marred when the Regina's prop churned up mud and the crew had to scramble to lower an antenna before it was smacked into the Bayonne Bridge. The harbor was too shallow, and the tug too low. It was an omen: The future of shipping had come to call—but not here, the harbor was found wanting. The Regina is soon to be followed by even larger cargo ships that are generating an upheaval in the maritime industry, especially in the North Atlantic, where outdated ports can't meet the needs of the new vessels. With

Ports of Call

Five ports are vying for Sea-Land and Maersk's business in a competition that could transform the maritime industry.

- REGINA PORT AUTHORITY, NORFOLK, VA.
- HALIFAX PORT CORP., HALIFAX, NOVA SCOTIA
- RODE ISLAND PORT AUTHORITY, QUONSET POINT, R.I.
- PORT AUTHORITY OF NEW YORK-NEW JERSEY
- PORT OF BALTIMORE, MD.

ADVANTAGES

- Terminal expansion under way; strong road and rail connections
- A 60-foot main channel and good location
- Planning to build a modern facility from the ground up
- Biggest population center in the country and the carriers' busiest port of call
- Good rail and access to the Baltimore-Washington corridor

EDITED BY AMY DUNKIN

WHEN A 'CARVE-OUT' IS A GOOD DEAL

Taking a page from a popular playbook, Barnes & Noble recently unveiled plans to sell a minority stake in its online operations via an initial public offering. For the nation's largest bookseller, there's an allure to this special type of deal, which is known on Wall Street

as a partial spin-off, or "carve-out." Hoping to exploit the fancy prices the market is still awarding Internet companies despite equities' recent decline, Barnes & Noble can expect to collect \$100 million or more from outside investors hungry to get in on barnesandnoble.com. But by spinning off only a part of barnesandnoble.com, the parent will still be able to maintain firm control over its growing unit.

RICH OFFSPRING. Similar thinking lies behind lots of recent deals, including CBS's pending carve-out of its radio and outdoor-advertising properties (table). In a variation on the theme, General

Motors is readying what may prove the biggest such deal yet, a two-step spin-off of parts maker Delphi Automotive Systems. In the first step, expected early next year, GM would sell a minority stake in Delphi via an IPO, spinning off the balance to

the auto giant's shareholders later

in the year. That would mimic AT&T's wildly successful 1996 spin-off of Lucent Technologies. The first step helps the parent raise capital while also allowing the market to set the unit's value before the balance is given over to shareholders, usually some months later.

If you're thinking of buying carve-out shares—whether you already own stock in the parent or not—you've got some homework to do. Carve-outs have complications that don't exist in conventional spin-offs, in which a company simply distributes to shareholders stock in one of its businesses. A

carve-out is a special kind of spin-off in which a parent company, instead of handing out shares in a subsidiary directly to current stockholders, sells a partial interest in an IPO. The parent benefits by getting cash from the IPO. Sometimes, too, the parent will fol-

INVESTING



Carve-Outs Past and Pending

PARENT (TICKER)	PRICE*	CARVE-OUT	PRICE*	STATUS
BARNES & NOBLE (BKS)	\$28.12	barnesandnoble.com	NA	Expected this year
CBS (CBS)	27.94	Infinity Broadcasting	NA	Expected this year
CINCINNATI BELL (CSN)	23.50	Convergys (CVG)	\$12.00	Done Aug. 13 at \$15
GENERAL MOTORS (GM)	59.44	Delphi Automotive	NA	Early 1999
NEWS CORP. (NWS)	25.44	Fox Entertainment (FOX)	NA	Expected in Nov.
PEPSICO (PEP)	31.44	Pepsi-Cola Bottling	NA	Under consideration
REPUBLIC INDUSTRIES (RII)	17.50	Republic Services (RSG)	\$15.94	Done July 1 at \$24
VIACOM (VIA)	60.25	Blockbuster Entertainment	NA	Late 1999

*Sept. 4

DATA: HIGH YIELD ANALYTICS, STANDARD & POOR'S, BUSINESS WEEK

low the initial carve-out with a spin-off of its remaining stake in the subsidiary directly to the parent's stockholders. Many times, the gives shareholders stock in two companies worth more than the parent's stock beforehand. And the offspring stock may outperform the parent's. Witness Lucent vault to more than \$108 a share, from \$13.50 each, in two years, while AT&T shares haven't even doubled.

But sometimes, the parent itself becomes more valuable. Take Barnes & Noble, which hopes its online unit will co-

and a market multiple akin to the more than 10 times estimated 1998 revenue that online leader Amazon.com's 1.4 billion market value suggests. Apply that same multiple to Barnes & Noble's Internet operation, and it would reach a market value of at least \$500 million. That's more than one-quarter of the parent's total capitalization, even though it contributes less than 2% of total sales. Look at the numbers, and you can see how the market's

appreciation of Internet operations

nell, author of *Spin-off to Pay-off* (McGraw-Hill, \$50), notes that shares in the parent have been trading around \$22, while Nabisco stock is around \$33. True, RJR has been dragged down by fears it will face huge tobacco liabilities. But at current prices, the market is awarding the cookie unit alone a value equivalent to the market value of the entire tobacco and cookie company. In other words, at \$22 a share you could buy RJR Nabisco and essentially pay nothing for the tobacco unit. "Some-

nesses and pay off in higher profits over time.

In a recent paper, the professors describe how they examined 83 carve-out deals from 1981 to 1990. They found that those companies, on average, saw faster growth in sales, operating income, capital expenditures, and assets than their industry rivals, producing higher returns on assets and sales. "Managers have stronger incentives to pursue shareholder value," says Penn State's Miles, who notes that 80% of the carve-outs in the study

an IPO, and the investment bankers who talk them up among institutions usually succeed in boosting their value—limiting the chance the market will underprice them. Investors in carve-outs also run a risk the parent's liabilities might eventually infect the subsidiary. Tobacco litigants, Cornell notes, would love to secure a claim to the cash flow from Nabisco's sales of Oreos and other snacks.

There's the worry, too, that the parent company will deal itself a better hand in any transactions with its carved-

out subsidiary. In August, Cincinnati Bell carved out its billing and customer service unit, Convergys, and sold 10% to the public with plans to spin off the remainder in a few months. Meantime, it is busily divvying assets, liabilities, and management talent. While no one has suggested any ill decision-making, Cincinnati Bell CEO John LaMacchia notes that the process requires a lot of judgment calls. "You try to be as fair as possible," he says. "But you can't just close your eyes and cut the

Do your homework. These deals have complications that conventional spin-offs don't. The offspring's stock can outperform the parent's—but the parent's sometimes may be a better bet

baby in half."

For investors, timing also is crucial. Cornell suggests waiting a bit after a carve-out to allow the effect of the underwriters' salesmanship to wear off. Cookie maker Keebler, 16% of which was sold to the public at \$24 a share last January, initially ran up almost to \$32. But by July it had sunk back nearly to \$24. Recently, however, the shares have been on the upswing even in the recent market plunge, as Keebler has unveiled acquisition plans, not to mention big jumps in sales and earnings. "These things fall through the cracks," Cornell notes. Then they're ready to be caught. *Robert Barker*



has become grossly inflated. Knowing that, it's hard to miss the point that owning the parent would be a better bet than buying the carved-out shares.

MAKING CLARITY. Researchers on Wall Street and in academia think it's a good idea to examine carve-outs this way. "It brings clarity to how people are valuing different parts of a business," says Joseph Cornell, director of equity research at High Yield Analytics.

RJR Nabisco may present just such an opportunity. It is two publicly traded entities—those of the parent RJR Nabisco and of snack maker Nabisco, 20% of which is owned by the public. Cor-

nell, author of *Spin-off to Pay-off* (McGraw-Hill, \$50), notes that shares in the parent have been trading around \$22, while Nabisco stock is around \$33. True, RJR has been dragged down by fears it will face huge tobacco liabilities. But at current prices, the market is awarding the cookie unit alone a value equivalent to the market value of the entire tobacco and cookie company. In other words, at \$22 a share you could buy RJR Nabisco and essentially pay nothing for the tobacco unit. "Some-

times," Cornell says, "the market doesn't get it." In these cases, investors seem to be overvaluing the carved-out stocks while overlooking values inherent in the parents. But sometimes investors fail to recognize the value in carve-outs. A trio of professors—Heather Hulbert of West Virginia University and James Miles and J. Randall Woolridge of Pennsylvania State University—found both carved-out units and the parent companies' shares returned more on average than industry rivals' shares. They think investors may be slow to catch on to the improved efficiencies and fresh capital investments that bolster carve-outs' underlying busi-

nesses and pay off in higher profits over time. In a recent paper, the professors describe how they examined 83 carve-out deals from 1981 to 1990. They found that those companies, on average, saw faster growth in sales, operating income, capital expenditures, and assets than their industry rivals, producing higher returns on assets and sales. "Managers have stronger incentives to pursue shareholder value," says Penn State's Miles, who notes that 80% of the carve-outs in the study

awarded stock options to executives, an incentive they may not have had as managers in a conglomerate. Just the same, experts think it's usually harder to outperform the market by snapping up carve-out shares quickly than with stock in a straight spin-off. After a spin-off, many investors dump the new shares without much thought. What's more, institutional investors who are tracking an index or hewing to some other rule may be required to sell. That creates temporary weakness in the price of the spin-off stock—an opportunity for buyers.

In contrast, carve-out shares enter the market in

COMMENTARY

By Christopher Farrell

WHY YOU STILL NEED STOCKS

In recent years, it has been drilled into everyone with a retirement savings plan or a mutual-fund portfolio that equities are superior long-term investments. After all, stocks in the postwar period have posted a compound annual return of 7.5%, after adjusting for inflation, vs. 1% for bonds. And as the bull market rocketed to new highs, the idea that bountiful returns came with a price of substantial risk became downright quaint. "Our firm has been preaching caution for about three years and feeling stupid," says Stephen Barnes, head of Barnes Investment Advisory in Phoenix.

No more. Since its July peak, the U.S. stock market is down sharply, and the carnage is far worse in emerging markets. The declines are a brutal reminder of something too long overlooked: Stocks are risky—it's the nature of the beast. "There is no free lunch, fountain of youth, or investment strategy that beats another by almost 7 percentage points with no extra risk," says University of Chicago finance professor John Cochrane.

MEAGER REWARD. Just what does "risk" mean in the stock market? Most people investing for retirement define it as the chance of having a meager reward—or an outright loss—when you need your savings to live on. Economists, however, use measures that essentially define risk as volatility. There's plenty of that now, in contrast to 1992 to 1995, when stock prices went straight up with few interruptions.

If all you had to do was wait out a correction or a bear market in anticipation of a lush long-term return, the risk of owning stocks would still be minimal. Indeed, the probability of doing poorly in stocks shrinks with

time. But it doesn't disappear. Since 1871, there have been at least 20 rolling 10-year periods when bonds outdid stocks. Before 1900, stocks lagged behind railroad bonds and did no better than commercial paper.

Bonds outdistanced stocks during the Great Depression, too. "History

assets were held in equity portfolios (another 21% was in company stock), says the Spectrem Group, a San Francisco financial-services research firm. Rather than shun equity risk, the right approach would be to include stocks in a portfolio diversified across a variety of assets.

For example, a portfolio that tracks the Standard & Poor's 500-stock index is down 0.6% on an annual basis this year. But a portfolio 70% in stocks and 30% in fixed income is up 1.3%, according to Ibbotson Associates, a Chicago-based financial research firm. Diversification is not simply creating a margin of safety. Since no one knows which markets will soar or sink, diversifying also gives investors an opportunity to catch the next big market upturn.

Going forward, stock returns may pale compared with those of the past 15 years. Still, if you can envision the U.S. economy remaining a leader among major industrial nations, you'll want to own stocks. If you believe the global economy will continue to expand—despite stomach-churning fits and starts—you'll want a slice of international equities.

Life, after all, is risky. Sure, you can put all your money in Treasury bills. They're risk-free, but that doesn't mean your portfolio will be. With their low return, T-bills may not generate enough income to provide adequately for your retirement. That's why you need to diversify. You'll expose parts of your portfolio to volatility and even outright losses. But that's the trade-off if you want higher returns for the long haul.

Contributing Economics Editor Farrell writes from St. Paul, Minn.



Sure, they're risky, but equities help boost returns over the long term

has few starting moments that come anywhere near resembling the current level of market valuations," notes Peter Bernstein, a New York-based economist and investment adviser. "This suggests that equity investments from here are going to fall short of swollen hopes and conceivably fall short of bond returns."

So should you now steer clear of domestic and international equities? Not at all. In fact, many people are far from being overexposed to stocks. Last year, 40% of 401(k) plan

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ROAD ROCKETS FOR THE JADED

You know who you are: Mr. Finicky, Ms. Never-Quite-Satisfied. You're a car nut,

and lots of exotic autos have graced your garage. But have you attained automotive nirvana? Nope. Ferraris leave you flat. Vipers seem vapid. What you want is a sports car that puts the "limited" back in limited production—something unique, something that Harry in Accounting would never dream of owning. But what kind of vehicle might that be?

Perhaps you should consider one of the boutique sports cars that are produced in tiny numbers for well-heeled collectors: cars like the Raptor, a coupe made by Florida hedge fund manager Warren Mosler. Or maybe you would prefer the Shelby, which was created by former racer Carroll Shelby for a select few enthusiasts. Then there's the Panoz AIV, built by pharmaceutical tycoon Donald Panoz and his son, Daniel. Chances of seeing your neighbor in one are nil—only a few hundred AIVs are made per year (table).

BIKE FENDERS. Let's start with the Panoz, since, at a selling price just under \$60,000, it's the most affordable. The two-seater is built in Braselton, Ga., close to the Road Atlanta racetrack that is the core of the Panoz racing empire. The AIV is sold by 21 outlets nationwide and

can be serviced at any local Ford dealer. The car comes with a three-year, 30,000-mile warranty.

The little runabout's bicycle fenders stir memories of such classic 1950s race cars as the Allard and Bristol.

ment seemed odd: The clutch is too far to the left and too high off the floor. I found myself driving with my left leg cocked awkwardly.

Conclusion: A distinctive, well-crafted sports car that's nicely finished, the AIV is bet-



SHELBY SERIES I

Base Price:

\$106,975

Except for the retro design, everything about the car is high-tech, from the aluminum space frame and double-wishbone suspension to the slick carbon-fiber body

But those throwback looks are deceptive. Underneath its composite skin, the car is 70% aluminum, the chassis supertaut and strong. Suspension is independent, and power comes from a 4.6-liter, 305-horsepower Ford V-8.

Put that engine in the 2,595-lb. Panoz, and you have a rocket. "The AIV has charm, but it's also an excellent performance car," says Danny Panoz. "Think of it as a four-wheeled motorcycle."

I gave Panoz' creation the ultimate torture test: a sprint up Manhattan's West Side Highway. Straight-line performance was sizzling. But the stiffly sprung AIV was easily unsettled over bumps, and it had a tendency to jump sideways. The steering felt twitchy. And pedal place-

ter suited for stately jaunts to the country than for high-speed touring. But what other car could you drive that leads jaded New Yorkers to wave madly and moved one cabbie to shout "God bless you, sir"?

If you crave more performance, Carroll Shelby has the answer in his new Series I roadster. The Texan's legendary Cobras ruled the

frame to the competition-style double-wishbone suspension and the slick carbon-fiber body. The Shelby weighs just 2,600 lbs. and is powered by a 4-liter, 325-horsepower Oldsmobile Aurora V-8.

In a test at Las Vegas Motor Speedway, the Shelby was impressive. The acceleration was smooth and immediate, and the big 12-inch brakes and six-speed trans-

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PANOZ AIV ROADSTER

Base Price:
\$60,000

The throwback looks are deceptive. The car is 70% aluminum, the chassis is supertight and strong, and the suspension is independent

mission felt solid. The handling was out of this world: The car's advanced suspension permits it to corner nearly flat, and yet the ride doesn't feel harsh.

The overall finish of the car was good. Since production will come to an end after 500 of the vehicles are sold, the Shelby should hold its value. Available through 17 Oldsmobile dealers, the Shelby costs \$106,975.

"BUCKET OF BOLTS." You could buy 2½ Corvettes for that much money. But to aficionados such as Ira Epstein, vice-president of Michael Lewis Co., a family-run food-service distributor near Chicago, it's worth it. "Ever since the '60s, I've wanted a Cobra," says Epstein, 54. "I owned a replica and got tired of the bucket-of-bolts ride. This car has a classic look, but it's for the age we live in now."

Shelbys are selling briskly: In Vegas, I met one high

roller who has bought five of them for resale. But they're still available. You can take the car to any Oldsmobile dealer to get warranty work. Shelby is serious about the limited edition of 500 cars. "When I'm done, there ain't gonna be no more," he drawls. And to show he's a sport, he'll throw in an embossed leather jacket that'll make you the envy of the hot-rod set. You also get flown to the Las Vegas race track for driver training—which is highly recommended in a car that goes from 0 to 60 mph in less than five seconds.

Both the Panoz and the Shelby are fairly civilized cars that balance speed with comfort. But if you want to motor far—really far—from the madding crowd, give Warren Mosler a call. He has poured millions into his passion: producing superfast, uncompromising sports cars that are just a heartbeat

away from purebred racers.

Like their creator, Moslers are quirky. Think kit-car quality. Think dune-buggy panels. Think parts that go thunk in the night. When Mosler picked me up at the West Palm Beach (Fla.) airport in one of his earlier cars, the Intruder, a misfire was evident. A later model Mosler that I drove was fast but lacked the smoothness of competitors.

SLEEK AS A SQUID. A former amateur road racer, Mosler began making composite-bodied cars back in 1986. Today, his Riviera Beach plant in Florida is all set to launch the \$149,000 Raptor as a '99 model. Low and sleek as a squid, it comes with a lusty 450-horsepower Corvette V-8 engine that is mounted behind the driver. At 2,400 lbs., the Raptor should eat other cars for lunch. "I sell to doctors, lawyers, and Wall Street types," says Mosler. "These people all want the ultimate

performance experience.

Maybe they're also mechanically inclined, because I suspect that the Raptor may take more than the usual tinkering to keep it humming. "This is a piece of weaponry like an SR-71 [spy plane]," says the affable Mosler. "People that fly one of those don't say: 'Oh, it leaks.'" Maybe. But if you buy the car, Pentagon-size maintenance budget wouldn't hurt.

Would any of these specialty cars lead me to dump my Porsche, which is still my idea of the benchmark '90 sports car? Hardly. I'm hooked on Teutonic perfection and a zero-tolerance repair budget. But if, like Ira Epstein, you've driven just about everything else and don't care about having a bags, then one of them might be for you. He says that as soon as his new Shelby is delivered next spring, his '90 Porsche Carrera is going to get the boot. *Lee Walczak*

MOSLER RAPTOR

Base Price

\$149,000

The engine is a 450-horsepower Corvette V-8 mounted behind the driver. This car "is a piece of weaponry, like an SR-71 [spy plane]," says creator Warren Mosler



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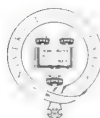
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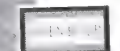
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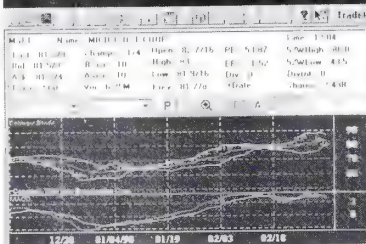
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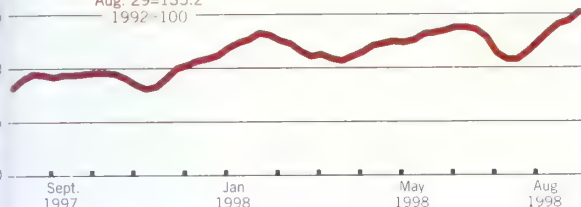
Business Week Index

PRODUCTION INDEX

Change from last week: 0.6%
Change from last year: 3.8%

PRODUCTION INDEX

Aug. 29=135.2
1992=100



The index is a 4-week moving average

The production index continued to rebound during the week ended Aug. 29. For calculation of the four-week moving average, the index jumped to 136.2 from 134.8, as auto, truck, and electric power production increased strongly. For the month of August, the index surged 2.7% to 135.2, from July's reading of 132.5. The month's robust advance mostly reflected a bounceback in vehicle production following the strike at the General Motors Corp.

Source: U.S. Commerce Dept., Bureau of Economic Analysis

LEADING INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STOCK PRICES (9/4) S&P 500	973.89	1027.40	4.8
CORPORATE BOND YIELD, Aaa (9/4)	6.44%	6.52%	-11.2
MONEY SUPPLY, M2 (8/24) billions	\$4,237.1	\$4,232.7r	7.0
INITIAL CLAIMS, UNEMPLOYMENT (8/28) thous	302	301r	-6.8
PERMIT APPLICATIONS, PURCHASE (9/4)	305.1	269.4	42.1
PERMIT APPLICATIONS, REFINANCE (9/4)	1,924.0	1,331.5	272.7

Sources: Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Bankers Assn. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
FEDERAL FUNDS (9/8)	5.66%	5.75%	5.50%
COMMERCIAL PAPER (9/8) 3-month	5.43	5.44	5.51
CERTIFICATES OF DEPOSIT (9/9) 3-month	5.48	5.52	5.60
FIXED RATE MORTGAGE (9/4) 30-year	6.90	7.02	7.68
ADJUSTABLE MORTGAGE (9/4) one-year	5.69	5.72	5.73
LIBOR (9/9)	8.50	8.50	8.50

Sources: Federal Reserve, HSH Associates, Bloomberg Financial Markets

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (9/5) thous. of net tons	2,112	2,040#	-2.7
AUTOS (9/5) units	111,726	130,121r#	20.9
TRUCKS (9/5) units	118,641	132,976r#	13.9
ELECTRIC POWER (9/5) millions of kilowatt-hrs.	NA	80,335#	NA
CRUDE-OIL REFINING (9/5) thous. of bbl./day	NA	15,688#	NA
COAL (8/29) thous. of net tons	22,258#	21,973	6.6
LUMBER (8/29) millions of ft.	494.4#	493.4	-0.4
RAIL FREIGHT (8/29) billions of ton-miles	27.2#	27.3	2.6

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WWPAl, SFPAl, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (9/9) \$/troy oz.	283.450	280.150	-11.6
STEEL SCRAP (9/8) #1 heavy, \$/ton	91.00	91.00r	-34.8
COPPER (9/4) ¢/lb.	78.4	77.4	-21.8
ALUMINUM (9/4) ¢/lb.	66.5	64.5	-12.5
COTTON (9/5) strict low middling 1-1/16 in., ¢/lb.	72.43	72.81	2.7
OIL (9/8) \$/bbl.	14.18	13.67	-26.1
CRB FOODSTUFFS (9/8) 1967=100	219.51	213.55	-8.1
CRB RAW INDUSTRIALS (9/8) 1967=100	285.19	283.33	-15.4

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (9/9)	137.30	137.70	119.15
GERMAN MARK (9/9)	1.73	1.75	1.80
BRITISH POUND (9/9)	1.66	1.67	1.59
FRENCH FRANC (9/9)	5.79	5.88	6.04
ITALIAN LIRA (9/9)	1704.5	1732.0	1755.3
CANADIAN DOLLAR (9/9)	1.52	1.54	1.38
MEXICAN PESO (9/9)	10.320	9.965	7.773
TRADE-WEIGHTED DOLLAR INDEX (9/9)	112.1	113.4	106.3

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan

Our data in the production indicators are seasonally adjusted in computing the BW index (chart); other components (estimated and not listed) include machinery and defense equipment. 1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

THE WEEK AHEAD

SALES

Friday, Sept. 15, 8:30 a.m. EDT ▶ Retail sales probably increased 0.4% in August, the median forecast of economists surveyed by Standard & Poor's MMS, a unit of McGraw-Hill Companies. Excluding vehicle purchases, store sales likely rose 0.3%. July, a steep decline in car sales led to a 4% drop in overall retail buying. Excluding vehicle sales, sales rose 0.5%.

BUSINESS INVENTORIES

Wednesday, Sept. 16, 8:30 a.m. EDT ▶ Inventories held by manufacturers, wholesalers, and retailers probably increased a small % in July, after a 0.1% gain in June, says S&P MMS report.

INDUSTRIAL PRODUCTION

Wednesday, Sept. 16, 9:15 a.m. EDT ▶ Industrial output probably rebounded strongly in August, rising 0.7%. The General Motors Corp. strike caused output to drop 0.6% in July. The average operating rate likely rose to 81.1% last month, from 80.5% in July.

BELIEF BOOK

Wednesday, Sept. 16, 2 p.m. EDT ▶ The Federal Reserve's roundup of regional business activity will be released in advance of the Fed's policy meeting on Sept. 29.

CONSUMER PRICE INDEX

Thursday, Sept. 17, 8:30 a.m. EDT ▶ Total consumer prices likely rose 0.1% in August,

after increasing 0.2% in July, says the S&P MMS survey. Excluding food and energy, core prices likely also rose 0.2% in August, on top of a 0.2% advance in July.

INTERNATIONAL TRADE

Thursday, Sept. 17, 8:30 a.m. EDT ▶ The trade deficit probably widened again, to \$15 billion in July, after narrowing to \$14.2 billion in June. Exports were likely unchanged, while imports rose.

HOUSING STARTS

Friday, Sept. 18, 8:30 a.m. EDT ▶ Housing starts likely dropped to an annual rate of 1.65 million in August, after jumping 5.7% in July, to a 1.72 million pace.

This Week, Online

Business Week presents frequent live conferences and chats on America Online—your opportunity to ask questions about timely topics.

Sunday

Ed Yourdon wrote *Time Bomb 2000* to warn about what Y2K will do to our computers—and he'll answer your online questions in this BW Enterprise chat. **Sept. 13 9 p.m. EDT**

Tuesday

What now for small caps and IPOs? Standard & Poor's analyst Mark Basham will tell all in a chat co-hosted by S&P Personal Wealth. **Sept. 15 4:30 p.m. EDT**

Thursday

All you need to know about valuing stocks, courtesy of Jeffrey C. Hooke, co-author of *Security Analysis on Wall Street*. **Sept. 17 9 p.m. EDT**

AOL keyword: BW Talk

Transcripts of all conferences are available for downloading from the BW Online area on AOL soon after each event

Index to Companies

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names. Companies listed only in tables are not included.

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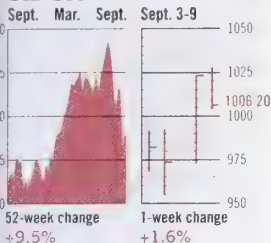
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Investment Figures of the Week

STOCKS

S&P 500



COMMENTARY

Fed Chairman Alan Greenspan hinted on Sept. 4 that he might lower interest rates to alleviate the global financial crisis. Mulling that over Labor Day weekend, investors returned on Sept. 8 and started buying again. The Dow Jones industrials jumped 380.5 points, nearly 5%, the best one-day gain ever. Though it gave back 158.3 points on Sept. 9, the Dow still managed to finish up 1.1% for the week—making it the best week for the blue chips in the last two months. Japan and especially Hong Kong, up 7.5%, enjoyed rebounds, but Europe's bourses had mixed results.

U.S. MARKETS

	Latest	% change Week	% change Year
Dow Jones Industrials	7865.0	1.1	1.9
NASDAQ Combined Composite	1624.6	2.0	-0.9
S&P MidCap 400	299.2	1.8	-7.3
S&P SmallCap 600	148.1	-0.2	-18.3
S&P SuperComposite 1500	211.7	1.6	6.6

SECTORS

	Latest	% change Week	% change Year
Bloomberg Information Age	336.5	3.2	15.0
S&P Financials	106.9	-2.5	-0.1
S&P Utilities	237.6	2.3	17.6
PSE Technology	309.0	2.9	-5.9

FOREIGN MARKETS

	Latest	% change Week	% change Year
London (FT-SE 100)	5311.3	1.4	8.3
Frankfurt (DAX)	5040.9	1.4	24.5
Tokyo (NIKKEI 225)	14,755.5	2.6	-21.1
Hong Kong (Hang Seng)	7905.5	7.5	-46.6
Toronto (TSE 300)	5871.8	3.3	-13.3
Mexico City (IPC)	3167.3	-0.4	-34.3

FUNDAMENTALS

	Latest	Week ago	Year ago
S&P 500 Dividend Yield	1.54%	1.58%	1.63%
S&P 500 P/E Ratio (Last 12 mos.)	24.3	22.8	23.6
S&P 500 P/E Ratio (Next 12 mos.)*	19.5	18.9r	16.6
First Call Earnings Revision*	-4.69%	-3.78%	-0.44%

TECHNICAL INDICATORS

	Latest	Week ago	Reading
S&P 500 200-day average	1061.0	1059.9	Negative
Stocks above 200-day average	18.0%	15.0%	Positive
Options: Put/call ratio	0.58	0.81	Negative
Insiders: Vickers Sell/buy ratio	0.98	1.03	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Electric Companies	5.0	Broadcasting 60.9
International Oil	4.5	Drug Chains 54.7
Food Chains	3.4	Drugs 49.6
Foods	2.7	Long-Dist Telecomms. 49.4
Restaurants	2.3	Specialty Appar. Retailers 45.3

WORST-PERFORMING GROUPS

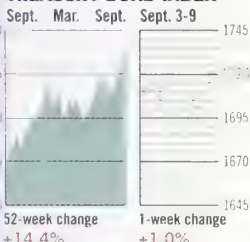
	Last month %	Last 12 months %
Invest. Banking/Brkrge.	-31.5	Oil & Gas Drilling -58.0
Money Center Banks	-28.1	Metals -51.0
Leisure Time	-22.9	Leisure Time -47.7
Shoes	-22.2	Shoes -42.1
Soft Drinks	-21.4	Engineering & Constr. -40.9

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness	Price	1-month change
Intel	81 ²⁹ / ₃₂	-4 ²⁹ / ₃₂
Citicorp	98 ¹¹ / ₁₆	-53 ¹³ / ₁₆
Merck	125 ¹ / ₂	-9 ⁸ / ₈
America Online	95 ¹ / ₄	-17 ¹ / ₂
IBM	125 ¹⁵ / ₁₆	-3 ¹⁵ / ₁₆
BankAmerica	63 ³ / ₈	-19 ¹⁵ / ₁₆
Decline ahead? Stocks with most significant selling on price strength	Price	1-month change
Dell Computer	59 ¹⁵ / ₁₆	4 ¹³ / ₁₆
American Home Products	52 ³ / ₁₆	¹⁵ / ₁₆
British Petroleum-ADR	80 ³ / ₁₆	4 ³ / ₁₆
Royal Dutch Petroleum-NYS	49 ¹⁵ / ₁₆	2 ¹ / ₁₆
Kellogg	33 ³ / ₈	2 ¹ / ₄
BMC Software	51 ¹ / ₄	¹ / ₂

INTEREST RATES

TREASURY BOND INDEX



KEY RATES

	Latest week %	Week ago %	Year ago %
MONEY MARKET FUNDS	5.10	5.11	5.16
90-DAY TREASURY BILLS	4.85	4.91	5.11
6-MONTH BANK CDS	5.05	5.05	5.17
1-YEAR TREASURY BILLS	4.79	4.91	5.61
10-YEAR TREASURY NOTES	4.93	5.10	6.37
30-YEAR TREASURY BONDS	5.27	5.34	6.66
LONG-TERM AA INDUSTRIALS	6.27	6.28	7.12
LONG-TERM BBB INDUSTRIALS	6.80	6.88	7.53
LONG-TERM AA TELEPHONES	6.53	6.65	7.43

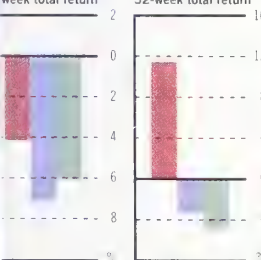
BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond Latest week	10-yr. bond Last week	30-yr. bond Latest week	30-yr. bond Last week
GENERAL OBLIGATIONS	4.24%	4.24%	4.88%	4.88%
PERCENT OF TREASURIES	86.05	83.60	92.67	91.42
TAXABLE EQUIVALENT	6.14	6.14	7.07	7.07
INSURED REVENUE BONDS	4.41	4.42	5.04	5.05
PERCENT OF TREASURIES	89.50	87.15	95.71	94.61
TAXABLE EQUIVALENT	6.39	6.41	7.30	7.32

MUTUAL FUNDS

■ S&P 500** ■ U.S. Diversified ■ All Equity
week total return 52-week total return



EQUITY FUNDS

Leaders	Laggards
Four-week total return %	Four-week total return %
Guinness Mainland China 23.2	Lexington Troika Russia -51.3
Guinness Flight China 16.5	Montgomery Latin Amer. R -36.9
Prudent Bear 16.4	Excelsior Latin America -35.7
Newport Greater China A 16.1	Invesco Latin American Gr. -35.2
U.S. Global Inv. China Reg. 13.9	Offitbank Latin Amer. Select -33.3
Leaders	Laggards
52-week total return %	52-week total return %
Smith Barney Telecomms. Inc. 43.3	Lexington Troika Russia -87.9
Weitz Hickory 38.5	Guinness Flgt. Asia Sm. Cap -67.3
Invesco European 35.2	Lex. Crosby Sm. Cap Asia -65.4
Janus Twenty 34.7	Matthews Korea I -65.1
Scudder Greater Europe Gr. 34.0	Montgomery Emerg. Asia R -65.0

EQUITY FUND CATEGORIES

Leaders	Laggards
Four-week total return %	Four-week total return %
Pacific/Asia ex-Japan 4.0	Latin America -28.1
Precious Metals 3.1	Diversified Emerging Mkts. -15.5
Japan 1.2	Small-cap Growth -11.5
Diversified Pacific/Asia 0.3	Small-cap Blend -11.0
Utilities -1.0	Small-cap Value -9.9
Leaders	Laggards
52-week total return %	52-week total return %
Utilities 16.8	Latin America -53.4
Europe 14.6	Pacific/Asia ex-Japan -52.5
Communications 14.2	Diversified Emerging Mkts. -47.2
Large-cap Growth 8.8	Diversified Pacific/Asia -40.1
Large-cap Blend 5.8	Precious Metals -39.6

data are as of market close Wednesday, Sept. 9, 1998, unless otherwise indicated. Industry tips include S&P 500 companies only. Fundamentals, technical indicators, Bloomberg money

flow analysis, and mutual fund returns are as of Sept. 8. For a more detailed explanation, write to us or E-mail figures@businessweek.com. r=revised **Vanguard Index 500 Fund

LESSONS FROM THE BRINK

Perhaps the only good thing about crises is that they can shatter accepted notions about how the world works.

Crises impart new lessons—if people are willing to learn. The current plight of the global economy is of such a scale that it offers many lessons. Some are new; others are reminders of basic truths. Here are the most important:

■ **Conventional Wisdom:** America's huge size insulates it from global problems. Overseas trade constitutes only 12% of the U.S. gross domestic product. Nearly 75% of the economy is in services, few of which compete internationally. A variation on this piece of wisdom is that the Federal Reserve focuses only on the U.S. and does not care about the global economy.

Reality: The stock market is telling anyone willing to listen that the U.S. is economically entwined with Asia, Russia, Latin America—virtually every part of the earth. In the first half of the year, the U.S. benefited from the recession beyond its borders. Lower prices for imports and commodities held down inflation and interest rates. But with half of the global economy now in the tank, with overseas demand falling, and with corporate profits under pressure, the U.S. is feeling the heat. Just look at the volatility on Wall Street. No way is the U.S. an economic island. Fed Chairman Alan Greenspan put it best: "It is just not credible that the U.S. can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."

■ **cw:** Free markets always lead to prosperity. The spread of laissez-faire capitalism around the world is inevitable, now that the cold war is over and the U.S. has won.

Reality: Freedom can also lead to anarchy. Asia and Russia are good reminders that the rule of law, regulation of banks, bankruptcy courts, accounting transparency, and a whole web of legal do's and don'ts are necessary to channel high octane, short-term capital flows to efficient investments. Without government playing a major role, international capital flows can lead to corruption, overcapacity, currency devaluations, recessions, and even a backlash against capitalism itself. Capital and foreign exchange controls are returning with a vengeance in Asia and Russia. Free markets need government action to work best.

■ **cw:** Currency devaluation stimulates exports, generates economic growth, and is a viable policy tool for the International Monetary Fund.

Reality: Despite devaluations ranging from 30% to 50% during the past 12 months, Pacific Rim countries are watching their exports contract. Korea's exports through August fell at a 28% annual rate. Exports from Indonesia, Russia, Thailand, and Venezuela—all undergoing IMF-prescribed therapy for their financial ills—are down sharply. Even Japan's exports are down. Why? A credit crunch trumps devaluation. Japan's ailing banks aren't lending. The second-largest economy should be growing and pulling in imports from all of Asia, but it isn't. Indonesian, Korean, and Thai companies should be taking advantage of their cheaper currency to export like mad—but they can't

borrow money to finance their exports. Devaluation is a double-edged sword. ■ **cw:** Inflation is the most serious threat to the world economy. Always has been, always will be. In the U.S., tight labor markets are causing rising wage inflation.

Reality: Deflation is the real wolf at the door, but few realize it because hardly any policymakers or corporate managers have lived through it. Japan, with a modern history of coping effectively with economic emergencies, is totally paralyzed by deflation. China, a proven expert at combating inflation, is sinking as prices fall. Brazil, the hyperinflation king, now sees prices declining as growth slows. The U.S.? Pricing power is being lost in industry after industry as deflation spreads. Prices for autos are falling, and the consumer price index is trending toward zero. The stock market bust could crack open more deflationary eggs, as a negative wealth effect ripples through housing, construction, and durables.

■ **cw:** Profit growth is dead. A profit recession is under way that will end the U.S. bull market for many years to come. First Call Corp. cuts its estimate for third-quarter earnings growth from the 12.6% it foresaw in March to 1.9% in September. Analysts rush to cut earnings estimates for 1999.

Reality: A corporate backlash to restore profit growth is underway. A new wave of restructuring is picking up steam. U.S. corporate layoffs are back up to peak 1994 levels. Companies are rejecting big increases in prices from health-maintenance organizations. Plus, the dollar is beginning to work to their advantage as well. Willy-nilly, it is declining from its highs, increasing U.S. competitiveness and upping the translation gain to profits on foreign multinational earnings. The stage is being set for a return to healthy profit growth in the future.

Certainly there is plenty to worry about. There have been many surprising jolts to the global economy over the past months, including deflation, default, exchange controls, and even the reemergence of communism as a force in Russia. The backlash against free markets is startling.

The good news is that policymakers are beginning to understand that the prevailing economic conventional wisdom is changing. A new reality is emerging that must be the focus of their action. A coordinated easing of monetary policy already appears underway to battle the spreading deflationary recession. Greenspan has just said that Fed policy is poised to cut rates in the months ahead if the U.S. economy weakens, as probably will. The Bank of Japan has just cut interest rates and promised to pump liquidity into the banking system. And the European Central Bank is shifting from a tightening stance to easing.

Restoring liquidity is only the first step. The debt overhang crushing growth in emerging markets must be written down and swapped for long-term bonds. Taxes must be cut to bolster demand. And bank reform must be instituted in Asia and Russia to channel capital to investments, not cronies.

Policymakers are beginning to learn the lessons of the global economic crisis. But are they learning fast enough?

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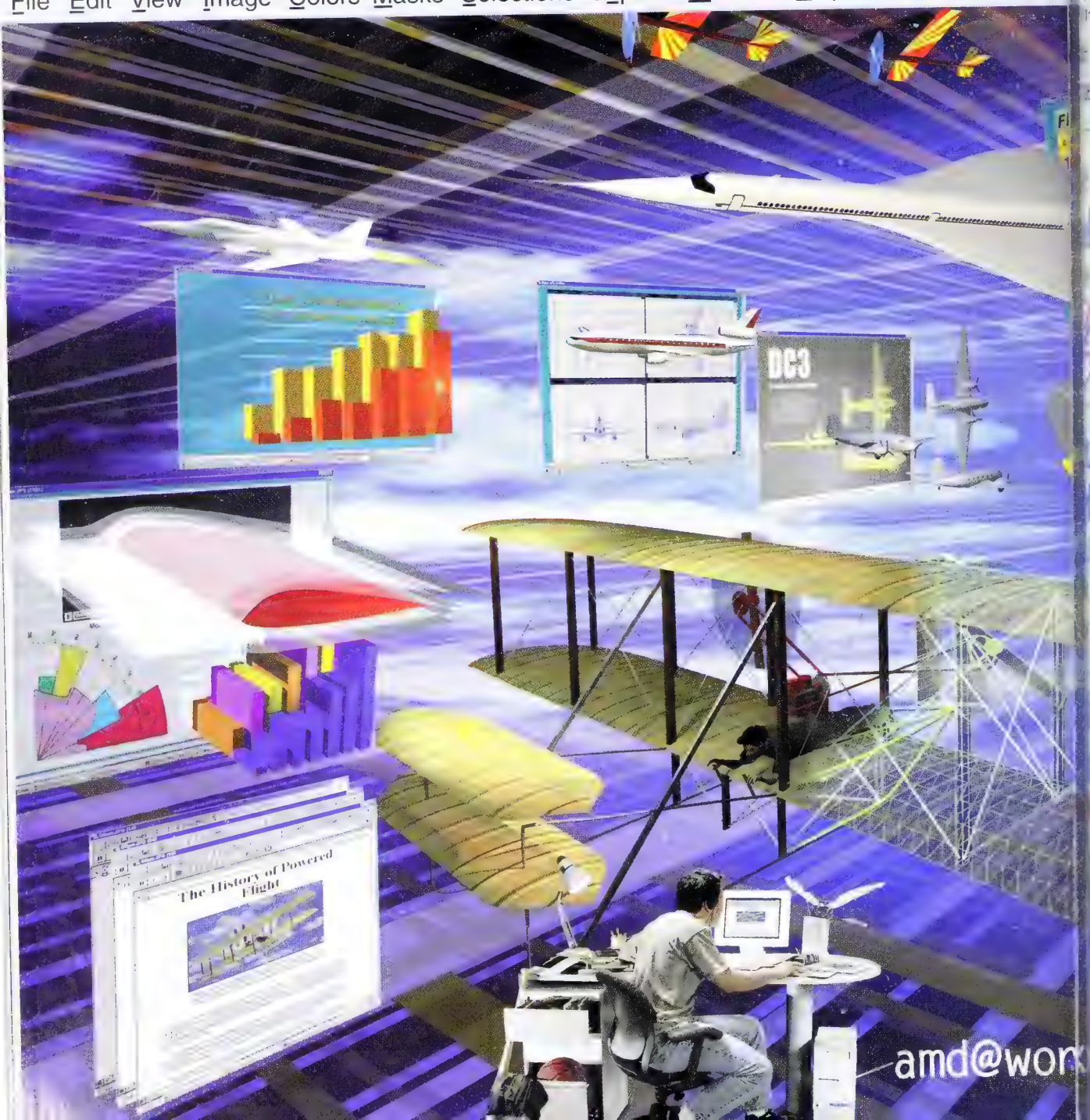
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CHAIRMAN FORD

His Roots, His Role, His Priorities

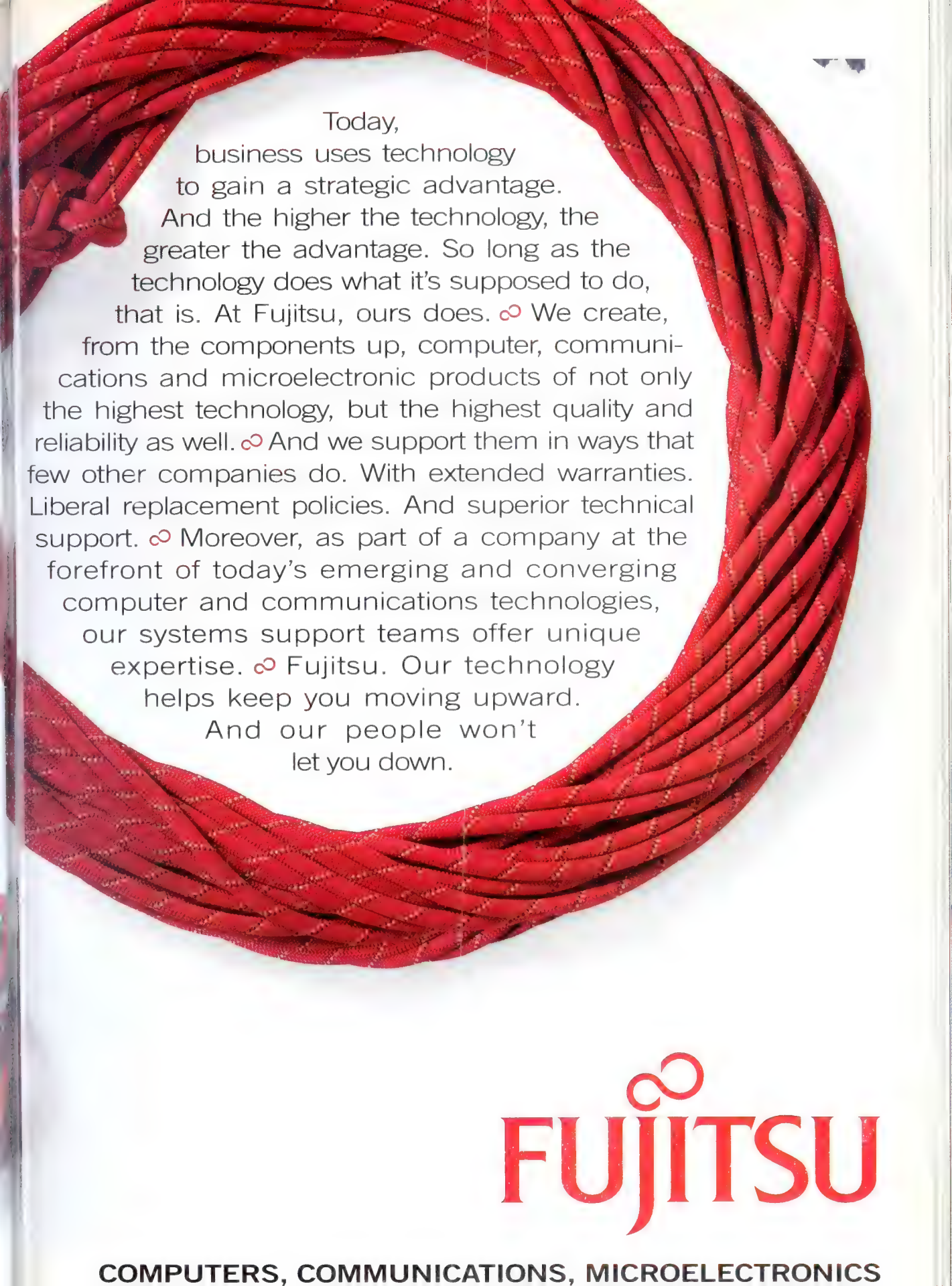
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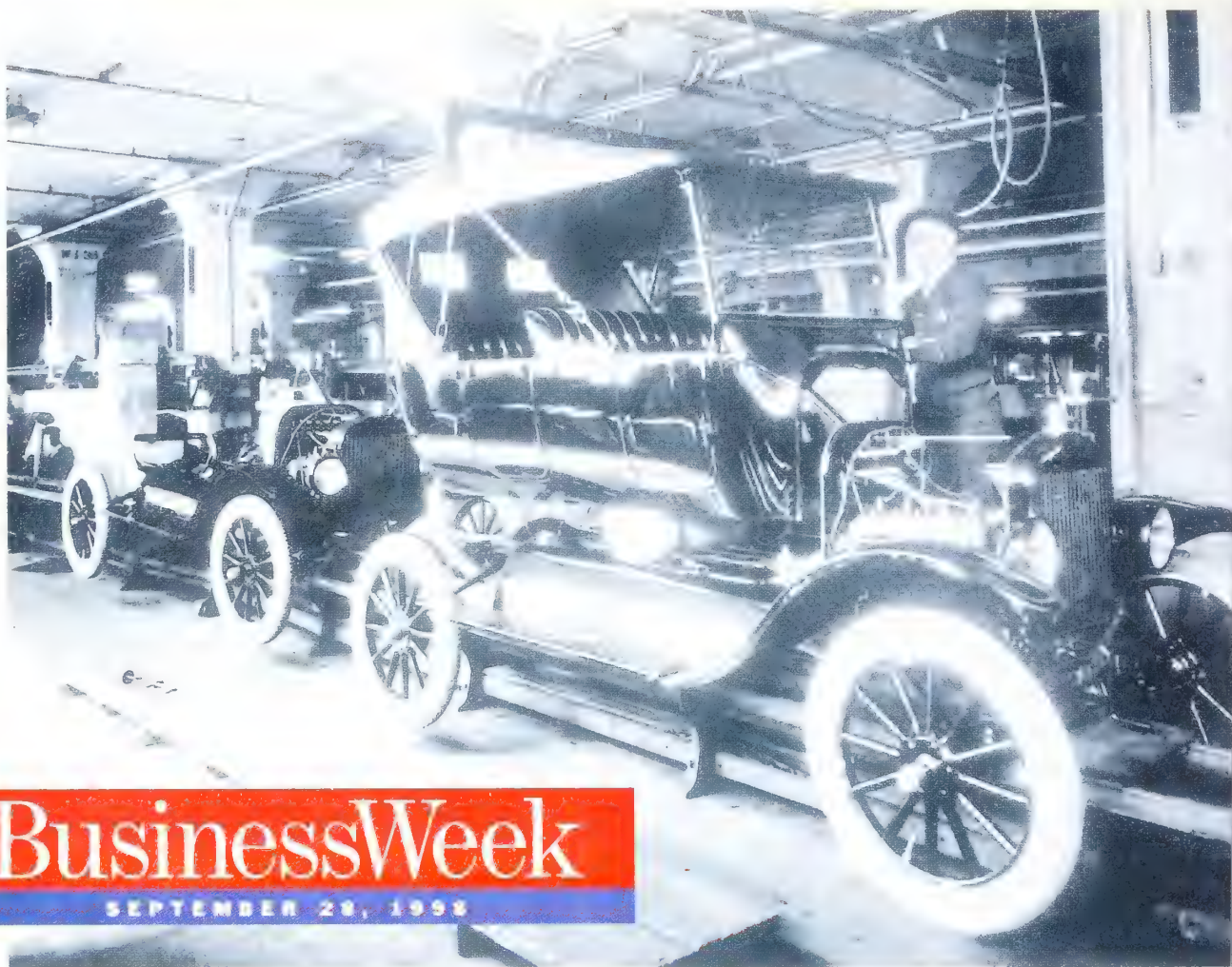
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BusinessWeek

SEPTEMBER 28, 1998

Cover Story

96 CHAIRMAN FORD

On Jan. 1, a fourth-generation Ford takes the wheel at the \$154 billion carmaker. William Clay Ford Jr., 41, a New Age industrialist who says he's "passionate" about the environment, is an avid sports fan—and by all accounts a fierce competitor. But is he up to the challenge of getting Ford roadworthy for the next millennium? At Bill Jr.'s side will be strong-willed CEO Jacques Nasser, who many say transformed Ford into the world's most profitable carmaker—but the record for such power-sharing deals is not good

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Central to his plan is a coordinated interest-rate cut and a restructuring of crippling Asian debt by the Group of Seven nations. Can he make it work?

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Are they a lifeline for devastated emerging-market economies—or a noose that would choke capital inflows?

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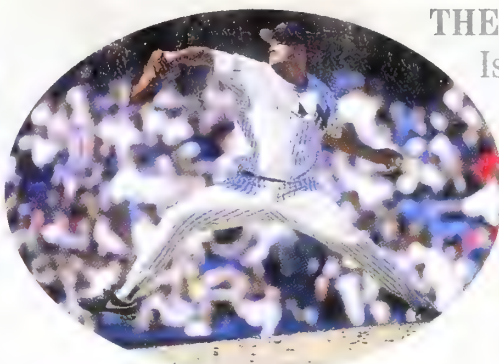
MAN FORD

years after the Model T, the family still is supreme. Now, Ford Jr. prepares to take over page 96



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tax credit that delivers, a scary inflationary scenario, iffy outlook for gold

BUSINESS OUTLOOK

the betting is for a rate cut, even though domestic demand remains solid

he Corporation

HEATING STARBUCKS

the company that made espresso a daily habit is at a crossroads. Retail sales are cooling, so it's looking to restaurants, supermarkets, and abroad to brighten its bottom line

Science & Technology

THE NEW FRACAS OVER FAT PILLS

Doctors have been prescribing combinations of Prozac and phentermine to fight obesity—but research suggests that they may pose the same dangers as fen-phen

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HotBot's search engine gets a search engine, a speedy CT scan, Ford puts a neural net chip under the hood

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Up Front

EDITED BY JOAN OLECK

THE FUND FRONT

A HEDGE FUND GETS CLIPPED

IT'S A DOUBLE whammy for Julian Robertson Jr. and his \$22 billion hedge-fund group, Tiger Management Corp.: Robertson recently told investors that the funds lost \$600 million in August from Russian-denominated debt. But September's news is worse: Tiger lost 12.6%, or about \$2 billion, between Aug. 28 and Sept. 8, according to performance figures for the offshore Jaguar fund, which mirrors the performance of all Tiger funds. It was one of the worst short-term declines in hedge

fund history, dwarfing even the 9.7%—or \$1 billion—George Soros' Quantum fund lost in August.

A Robertson spokesman declined to comment publicly on the reason for the drop. However sources close to the fund blamed a good part of the plunge on a bet on the dollar vs. the yen; the yen has climbed against the dollar in recent weeks.



ROBERTSON

Most of the loss took place in early September.

The Tiger funds are down 9% this month, through Sept. 15. Despite the recent losses, Tiger is up 15.9% this year, after fees. It is now the largest hedge fund group, surpassing Soros' Quantum group.

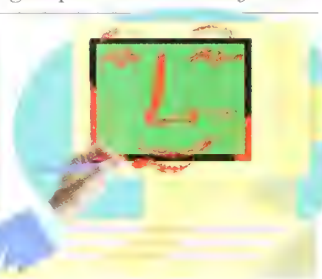
Gary Weiss

AFTERLIVES

MAKING TECHNOLOGY IDIOT-PROOF

FOR ALL THE ADVANCES of late, computers and most high-tech gadgets are as frustrating as ever to use. Donald Norman, an ease-of-use expert who in the mid-1990s helped make Apple Computer's Macintosh line simpler to operate, understands this point. No device, he says, becomes ubiquitous until it's idiot-proof. The computer, now five decades old, is hardly that. Norman calls the computer "a 50-year-old teenager."

Now, Norman wants to spur the maturation process by teaming with Jakob Nielsen, a former Sun Microsystems Distinguished Engineer. Their Nielsen Norman Group will help companies make technology less com-



plex—from "information appliances" that need no booting to improved E-commerce Web sites.

Norman hopes to have more impact than he did at Hewlett-Packard—which he left after just one year. Indeed, his new book, *The Invisible Computer*, due in October, ends with his view of why big companies are so bad at innovation. "My goal at HP was to bring out products that hide the technology and bring out the benefits," he says. "I'll have bigger impact doing this as a consultant." Peter Burrows

TALK SHOW "I don't think there is a fancy way to say that I have sinned."

—President Clinton at a White House prayer meeting

THE DEAL MILL

COMPAQ STRIKES AN ALTA 'TUDE



COMPAQ COMPUTER MAY HAVE hit on a way to use the Internet to sell more PCs: Sources say the company is negotiating with Yahoo! and Time-Warner on a possible joint venture involving Compaq's search engine, AltaVista. Compaq acquired AltaVista with Digital Equipment in February.

Sources close to the negotiations say Compaq wants to trade equity in AltaVista for Internet content it could feed to Compaq PC customers. An alternative trade would be

broadband services, like the Internet and cable, for PC customers. Compaq's board may be asked to approve a partner in October, sources say. Compaq has already invested \$200 million in RoadRunner, Time-Warner's high-speed Internet service.

All three companies declined comment. But Compaq Chief Financial Officer Earl Mason this week told analysts of "negotiations with a couple of different partners" concerning AltaVista. Web researcher Relevant Knowledge calls AltaVista the 10th most-visited site of the Internet. This, plus its powerful Internet search technology, gives it a valuation of roughly \$400 million. Sounds big enough to cut a lot of deals.

Paul Jude

DEREG DIARY

YES, VIRGINIA, THERE IS PHONE COMPETITION

MAYBE THERE IS SUCH A thing as local telephone competition after all.

These days, the Federal Communications Commission is waving around a Merrill Lynch study that disputes the pundits who declare the 1996 Telecommunications Act an abject failure. With so many phone-company megamergers, the prevailing wisdom has been that the effort to spur competition has led merely to consolidation.

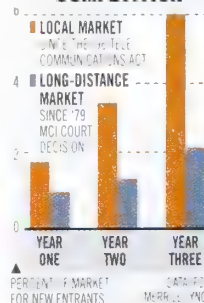
Not true, counters the FCC: Competition in the local calling market is moving faster than the 1980s battle over long distance. Two years after the act, rivals have captured 3.5% of local-phone revenues

from the Baby Bells, says Merrill. In contrast, two years after the 1979 court decision letting MCI sell long distance services, carriers had won only 1.4% of that market from AT&T, the FCC notes.

For next year, the third since deregulation, Merrill predicts that local competitors will control 6% of the market, most corporate business in metropolitan areas. The lesson: "It takes patience and persistence to move a market from monopoly to competition," says FCC Chairman William Kennard. Rivals needed years to cut AT&T's market share to 75%. So brace yourself for another round of those dinner-time telemarketing calls.

Catherine Yap

PACE OF TELECOM COMPETITION



FOOTNOTES Institutional investors' stake in the 1,000 largest U.S. corporations: 1987, 46.6%; 1997, 59.9%



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Up Front

THE GLOBAL ECONOMY

WESTERN WAYS FOR EASTERN MBAs

IN SEARCH OF NEW MBAS TO modernize its economy, China is ready to import the hallowed case-study method of Western business education to its universities. Educational authorities have decreed that the "top-down" Confucian and communist-style schooling, where students sit quietly for endless lectures, no longer cuts it.

So the University of Western Ontario's Richard Ivey School of Business has joined with Tsinghua University in Beijing and Fudan University in Shanghai to train Chinese B-school professors. No longer

will there be a "right" answer that students have to memorize. Instead, says Ivey professor Paul Beamish, students will engage in lively debate. A sample case study: the challenge China's Huaneng Power International Inc. faced in 1994 with its IPO. Students will be asked whether to



scrap the deal and delay funding new power plants in a poor IPO market. The 2,500 Chinese teachers who will teach the case method need to master it fast. Beijing says it wants

to graduate 200,000 MBAs annually by 2000—up from only 5,000 now. So the cases—25% of the curriculum—must be put into place quickly to produce that many Western-savvy business leaders. *Joseph Weber*

BON APPETIT

WELL, THE RUSSIANS LIKE IT



SHOEMATE: A bet on eating mayo

WANT TO SELL AMERICAN food products overseas? Then customize the vittles to local tastes. Visit a McDonald's in India, for example, and you'll find burgers made of mutton, not beef. Similarly, Bestfoods, makers of Hellmann's mayonnaise, hopes to top the market for the mayo Russkies love—a near-liquid version of the stuff. The taste is blander than the U.S. version, and it's poured

on vegetables rather than spread on bread.

So in a long-term bet on Russia's economy, the company is set to open a plant near Moscow in December. Bestfoods has peddled different mayos around the world for decades and has shipped a special Hellmann's—produced in the Czech Republic—to Russia since 1993. Now, the company figures that making mayo locally will be more cost-effective, but it won't disclose the cost.

Like several other American companies, such as RJR Nabisco (currently expanding its cigarette factory in St. Petersburg), Bestfoods is betting Russia's woes will abate. "We see a growth opportunity," says Chairman C.R. Shoemate. Although Hellmann's has only a small market share in Russia, where state-owned Moszhircom is the leader, its aim is to become No.1 or No.2. *Larry Light*

DRAWN & QUARTERED



PRODUCT PEEK

IT'S A GAME BOY! IT'S A FISH FINDER!

JAPAN MAY BE MIRED IN recession, but that has yet to stop the stream of nifty new gadgets that wind up in the U.S. The latest, Pocket Sonar, is half electronic game and half fish finder.

No, it won't lead you to a plate of sushi. But Pocket Sonar, co-developed by Honda Electronics—which makes fish sonar for professionals—and Bandai Co.—maker of the popular Tamagotchi—aids recreational anglers. Basically a floating device and underwater sensor, Pocket Sonar can



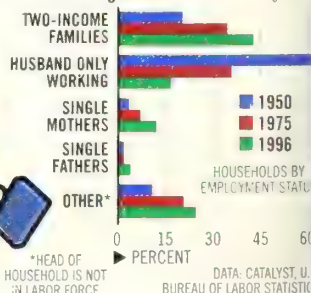
detect fish up to 65 feet away. It works with Nintendo's Game Boy: A cassette connected to the sonar device and plugged into the game machine shows any fish swimming by as symbols on a screen.

The 10,000 \$110 machines that hit Japanese stores in July already are sold out. And international sales seem certain. After all, Pocket Sonar allows study of the marine landscape and come equipped with a fish encyclopedia profiling 121 varieties of fish. It's also got this cool game function for the novice angler: Got no bites today? Then switch on the gadget game function that allow you to snag electronic fish instead. *Miki Tanikawa*

THE BIG PICTURE

WHEN SAYING GOOD-BYE IS EASY

Dual-worker families have doubled in number in five decades. And in a Catalyst survey, 67% say a working spouse makes it easier to leave a bad job. In 1981 only 20% said that.





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ONE WORLD, ONE CELL-PHONE STANDARD

As an international traveler, I feel little sympathy for Qualcomm Inc., Motorola Inc., and the other U.S. manufacturers of cell phones ("Cell phones: Europe made the right call," Science & Technology, Sept. 7). I have long envied the European move to the global system for mobile communications (GSM) standard. Every time I travel to Europe or Asia, I lament the fact that I cannot take my cell phone. Yes, technically better solutions were born from the competition fostered by the Federal Communications Commission, but true value to me is being able to use my phone anywhere. Have we forgotten Beta vs. VHS so soon? If third-generation code division multiple access (CDMA) is the wave of the future, then let's get on with it. The big money is made through volume, not bickering and turf wars.

John J. MacDonald
 San Ramon, Calif.

WHY KOREAN WORKERS PLAY FOR KEEPS

In "Korea Inc. Wimps Out Again" (International Business, Sept. 7), Moon Ihlwan makes observations typical of an outsider armchair economist's analysis. Moon asserts that the auto workers' strike at Hyundai Motor Co.'s Ulsan plant shows that the Korean people are massively resistant to change and that the government intervention in the potentially "bloody confrontation" sends a signal to the *chaebol* that mass layoffs are off-limits.

Moon seems to advocate that Korea's blue-collar workers should take the brunt of the economic crisis and assume all responsibility—for the good of the country, of course. What he does not seem to understand is that Korea does not have the social support systems that the U.S. and Sweden have. In Korea, once workers are laid off, they have no income. There is no social net, no Social Security, no unemployment insurance. Additionally, as typical Korean families are structured,

the male head of household is the only source of income. Laying off 1,500 workers, therefore, marks the end of subsistence for 1,500 families with wives and children. Why is it wrong for these workers to protect their means to survive?

I believe that the expression of anger and protesting against what is deemed injustice is healthy for a country like Korea. In the 50 years of the republic, Korean workers were exploited beyond imagination by the *chaebol* and the government. It is only in the last decade that the government allowed them limited free expression. For the government to thwart the people-led protest, using police and military force, would be a giant step back for Korea.

Hyunshuck Oh
 Brooklyn, N.Y.

HOW PRICES GET TWISTED OUT OF SHAPE

Robert Kuttner places the blame for Britain's prices on the wrong party ("Globalization's dirty little secret," Economic Viewpoint, Sept. 7). The answer to his question "Why, then, do Levi's jeans cost double in London what they cost in New York?" is simple: It's the government, stupid! The fact that Britons pay nearly double for some goods has nothing to do with "monopoly pricing" or U.S. multinational greed. Only when governments intervene (through regulation, tariffs, favoritism, etc.) does the law of price break down.

The exorbitant prices in Britain are the result of British government collusion with foreign corporations. If governments let corporations compete without intervening via regulations or by playing favorites, competition will ensue and lower prices will prevail. The solution is less government, not more.

Lance M. McInerney
 Bronxville, N.Y.

WHAT 'RED CARPET' TREATMENT REALLY MEANS IN CHINA

Regarding "Tough questions for an Ambassador" (Government, Sept. 7),

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CORRECTIONS & CLARIFICATIONS

"Half a Loaf at Blimpie" (The Corporation, Aug. 10) incorrectly described licensing agreements covering the Blimpie trademark. Blimpie International Inc. leased international rights to the Blimpie name in 1995 from Chief Executive Anthony P. Conza and Chief Operating Officer David L. Siegel, in advance of a \$10 million stock offering by Blimpie International. That trademark arrangement was separate from an agreement by Blimpie International four years earlier to buy international rights to the Blimpie name from a smaller Blimpie company.

The story also should have noted that in 1976, ownership of the original Blimpie entity was split 60% for Conza and Siegel and 40% for Peter DeCarlo, not in half between Conza and DeCarlo, as stated.

an understand wanting to set the tone or the story, but I disagree with characterizing normal occurrences as "red carpet" treatment. The "red carpet" treatment is, in fact, quite typical of the experience of the average American visiting Beijing, particularly if he or she is being hosted by a friend. Ambassador James R. Sasser lives in the ambassador's residence, and it is reasonable to expect him to host his friends.

The vast majority of American visitors to Beijing tour the Great Wall and often bring food along. In fact, since there is a real threat of getting the hepatitis virus from the food vendors, it is a matter of safety to bring one's own food. The cashmere markets and silk stalls are not luxury stores but normal flea-market-type places selling clothing and souvenirs of all types to all people. By exaggerating issues on one level, the credibility of the remaining issues is called into question.

Larry Hymson
Franklin Square, N. Y.

HAWAII'S NEW WAVE: ELECOM PROWESS

The successful linking of ProBio America, a biotechnology firm in Honolulu, with the University of Hawaii team of scientists involved in the latest cloning breakthrough was a remarkable story ("Human clones: It's decision time," News: Analysis & Commentary, Aug. 10). What is also remarkable is the fact that this sort of networking by high-tech firms and other businesses is happening with greater frequency in Hawaii, a state that has been known more popularly for its sun and surf.

Underlying the popular vision of Hawaii is a high-tech infrastructure, offering a world-class telecommunications network girded by high-bandwidth fiber-

optic technology that puts our state on the forefront of major business markets. Multiple fiber-optic cables linking Hawaii to the continental U.S. and the Asia-Pacific region have in effect erased the distances spanning state and international boundaries. Just as railroad expansion decentralized urban centers and stimulated new growth in the West, communications in Hawaii is becoming a catalyst for creating diversified economic growth.

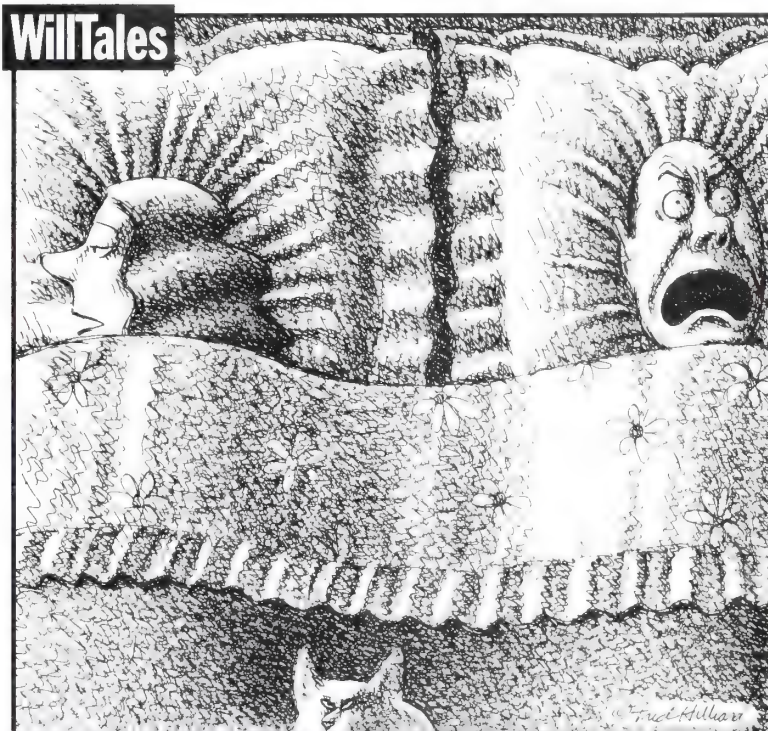
Benjamin J. Cayetano, Governor
Honolulu

LET THE IMF R.I.P.

Your call for interest-rate and tax cuts to help address the spreading threat of global deflation is well justified, especially given the historically high real cost of credit you cite. Your call for new money for the International Monetary Fund, however, is ill-considered and discredits your other arguments ("Give the IMF its due," Editorial, Aug. 3).

Expecting the IMF to promote "pro-

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Readers Report

growth" policies, as you suggest, is absurd. With one or two exceptions, the economists and other "professionals" who populate the IMF have not the slightest idea how to operate a private business or bank, much less direct the movements of a nation's political economy. Most (if not all) of the IMF gnomes could never find work in a for-profit company or financial institution at least not in those parts of said organizations related to operations or taking risk. Why should the world take advice from people who cannot play the game?

Use new money for the IMF to forgive loans and reduce debt, then close down this useless institution. Now that would help to promote pro-growth, free market policies.

Christopher Whaley
Croton-on-Hudson, N.Y.

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First Read of Decision Makers

BY STEPHEN H. WILDSTROM

A COMPUTER USER'S MANIFESTO

The sooner the industry adopts these common-sense precepts, the better

Did you ever get so angry with your computer that you wanted to take a baseball bat to it? Have you ever been stumped by some error message that bore no relationship to anything in the manual or the on-line help? Have you ever been cold in winter?

A leading computer-industry researcher feels your frustration. Clare-Marie Karat is a PhD psychologist who evaluates the way people interact with their computers and designs what the industry calls human interfaces at IBM's Thomas J. Watson Research Center in Hawthorne, N.Y. The problem, as she sees it, is simple: The engineers and computer scientists who design hardware and software know little about the needs and frustrations of consumers. "The technologists get far into the design of a system without really understanding who the target users are, the work that they do, and the context in which they do that work," Karat says. By the time feedback comes in, it's "way too late."

The results can be annoying, such as the progress indicator that claims a job is 90% finished when it's only half-done. Or you can have a catastrophe: programs or computers that don't work as promised or don't work at all.

To remedy this situation, Karat is challenging the industry to endorse a 10-point User's Bill of Rights:



KARAT: Companies don't understand who their customers are

1. The user is always right. If there is a problem with the use of the system, the system is the problem, not the user.

2. The user has the right to easily install software and hardware systems.

3. The user has the right to a system that performs exactly as promised.

4. The user has the right to easy-to-use instructions for understanding and utilizing a system to achieve desired goals.

5. The user has the right to be in control of the system and to be able to get the system to respond to a request for attention.

6. The user has the right to a system that provides

clear, understandable, and accurate information regarding the task it is performing and the progress toward completion.

7. The user has the right to be clearly informed about all system requirements for successfully using software or hardware.

8. The user has the right

me the impression that it was my fault if a product didn't work. I've sometimes given up on hardware and software because I couldn't get through the installation. I often hear from bewildered readers who get shuttled back and forth between hardware and software companies, each claiming that a problem is the other's fault.

Companies have paid lip service to ease of use, with useful but superficial changes such as color-coded cables. But on a deeper level, they don't realize that their customers aren't the tech-savvy enthusiasts who gave the industry its impetus. As Karat puts it: "The profile of the people who use systems has changed while the systems, and the culture in which they have developed, have not adjusted."

NEW PRIORITY. Currently, just under half of U.S. households have computers. Rates are much lower in the rest of the world. To get wider dispersion, manufacturers have to make PCs and the software as user-friendly

as toasters. That's going to take time, because the industry first has to change its way of thinking and then has to redesign products from the bottom up, with ease of use as the No. 1 priority.

It's easy to quibble over the specifics of one or another of Karat's proposed items. But add a point requiring all error messages to be comprehensible and explained in detail. But the important thing is for the computer industry to begin a dialogue that would lead to formal adoption of something very much like this User's Bill of Rights.

I'd like to know what you think of the idea. E-mail your comments to me at the address below.

I don't know how often tech-support people, not knowing that I was a technology columnist, have given

THE BILLIONAIRE SHELL GAME

How Cable Baron John Malone and Assorted Corporate Titans Invented a Future Nobody Wanted

by L. J. Davis
Hardcover • 292pp • \$24.95

JOHN MALONE AND THE CABLE TANGLE

You tend to remember meetings with John C. Malone. Big, square-jawed, with a ready wit and an intense dislike for those who disagree with him, the chairman of cable giant Tele-Communications Inc. tends to speak his mind and take no prisoners. "Those companies are never going to be the winners in this race," I recall him telling me when we sat in his Denver office in early 1995, a year after his celebrated \$35 billion merger with Bell Atlantic Corp. had completed. "They have too many layers of detritus weighing down their cost structure. You know, whale it."

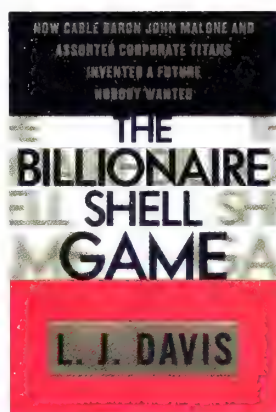
Since then, John Malone has been to his own private hell and back, watching as his company's stock price nose-dived while it built up its debt and customers defected to satellite TV. And through most of it, Malone was nowhere to be found, stoking rumors—since proven incorrect—that he was ill, soured on the cable industry, or just plain disinterested in running his once-robust company. But then there was the triumphant return, this June, when AT&T agreed to pay \$60 billion for the newly reenergized company.

Did anyone ever doubt that Malone, famously called the King of Cable and Darth Vader, would come back in glory? Certainly not L. J. Davis, author of *The Billionaire Shell Game*, a highly critical account of how the cable industry over-promised new technology in order to curry favor with Wall Street and, in Malone's case, to find a buyer for Tele-Communications. Davis, a contributing editor to *Harper's* magazine, figures that Malone has been angling for a billion-

dollar payday almost since the moment he took the reins of TCI in 1973 as a 32-year-old engineer who had befriended founder Bob Magness. Unwilling to pay taxes, he leveraged the company to the hilt to buy up any available system even if it meant losing millions. As for the TV viewer, says Davis, Malone couldn't care less: Better service and more channels meant higher costs, and if he spent more on existing subscribers, he would have to slow his march to build America's largest cable empire. "The trick," Davis writes, "was to never give the public what it wanted."

Which makes it all the more improbable, Davis argues, that Malone really wanted to build TCI into the provider of the interactive "500-channel universe," a phrase he coined in a speech to a trade group in Anaheim, Calif., in late 1992. TCI's cable systems, although serving the most subscribers in the country, tended to be small, rural outfits with outdated technology. Malone skimmed on upgrades, made headlines about ordering set-top boxes for digital channels, and then quietly put off buying the boxes when the technology was slow in coming. Indeed, just a few years earlier, Malone had quickly canceled tests of a promising interactive system called Qube after buying a Time Warner Inc. system that was testing it.

The Billionaire Shell Game contains many juicy anecdotes about Malone, including one in which he is said to have scuffled with an equipment vendor who didn't agree with his terms and the oft-told story of how TV screens in Vail, Colo., went blank when the city council contemplated taking away TCI's fran-



THE TRICK: "NEVER GIVE THE PUBLIC WHAT IT WANTED"

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nise. We watch as Malone strong-arms SPN into not raising the rates it charges TCI and as he double-crosses Barry Diller during the 1993 Paramount communications Inc. takeover battle. A word of caution: Davis' only direct communication with Malone was in a 1990 interview, and Davis' recent other TCI contacts have been limited to two technology execs. Thus, TCI officials say, the book is flawed and inaccurate in parts.

No one seems to come out looking good in Davis' view of the world. Malone is both evil and henpecked, moving to Denver to please his wife, Leslie, who wants her husband at home more than at the office. Time Warner Chairman Gerald M. Levin is an absent-minded professor who dresses shabbily and bores people with endless talk of technology. Levin also loses his company millions as he seeks follow-ups to the success he created at HBO by delivering its movies via satellite. As for

cell Atlantic Chairman Raymond W. Smith, he's portrayed as affable but affected "by an abiding madness that had reached its final form" as he sat across the negotiating table from Malone. Smith, Davis writes, was sure his company's future rested on increasing its ability to deliver TV over its phone lines, even if he couldn't understand why.

In the end, of course, Ray Smith early overpays for TCI, Congress limits cable's cash flow by reregulating its prices, and Bell Atlantic's due diligence turns up antiquated TCI cable systems and suspect digital technology. The deal falls apart, leaving John Malone to rebuild his company's image and look for another buyer. Now, as TCI and AT&T draft and redraft their merger documents, you know that AT&T's financial folks are going over the cable company's sets with a microscope.

It's a pity that Davis didn't have the time to do the same. His book provides a marvelous account of the early days of cable, when telephone companies didn't allow cable operators to string lines from their telephone poles. Davis skill-

fully tells the reader about John Walson Sr., a lineman for the Pennsylvania Power & Light Co. who gave birth to the industry by building a 70-foot antenna atop New Boston Mountain in Mahanoy City, Pa., and charging customers \$2 a month for a TV signal. Davis also introduces us to such cable pioneers as Bill Daniels, a former Korean War fighter pilot who helped finance cable operators in the years just after World War II, and lawyer Glenn Jones, who lived in his car while searching Colorado for cable systems to buy.

But Davis misses a key change in cable-industry strategy. After years of fighting telephone companies, cable outfits are starting to look like telecoms themselves. By trading systems, they have bunched cable subscribers into densely packed regions in major markets. That has helped cable companies, who have caught Internet fever, to sell thousands of high-speed

cable modems. Even TCI, after dragging its feet for years, has sped up its rollout of fiber-optic lines and begun taking deliveries of those elusive digital set-tops. Its connection to one-third of American homes was appealing to AT&T, which is eager to jump into local telephone service and expand its Internet services.

Make no mistake: John Malone still emerges as a winner. As Davis points out, he has carefully created a second kingdom for himself, Liberty Media Corp., the TCI unit that owns pieces of such cable channels as Discovery, Fox Sports, and the Home Shopping Network. And the 500-channel future that Malone and his "assorted corporate titans" envisioned has been altered to incorporate the Internet. Folks may never use their TV sets to order groceries or to download data from their local public libraries. But there is a money-making future for cable television, and whatever his motives, John Malone helped create it.

BY RONALD GROVER

Los Angeles bureau chief Grover has written extensively on the cable-television industry.

The juicy anecdotes include one about Malone scuffling with a vendor who wanted better terms



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BY ROBERT J. BARRO

WHAT MIGHT SAVE RUSSIA: TYING THE RUBLE TO THE DOLLAR



STABILITY
A currency board would exchange the ruble at a fixed rate, eliminating volatility and hyperinflation as threats to the economy

On a recent trip to Russia, I got an up-close look at some of its economic and political problems. The risks in the situation were evident, but it also seemed that the political turmoil might create opportunities for basic institutional changes. At times like these, drastic new policies sometimes become politically feasible, and it is therefore worth considering reforms that might otherwise be unthinkable.

One attractive proposal is a currency board, whereby the central bank would limit its activity to exchanging the ruble for foreign currency at a fixed rate. Since large quantities of U.S. \$100 bills are already circulating and since many domestic transactions are viewed effectively in dollar terms, the natural unit would be a new ruble that equaled one U.S. dollar. But the system could also work in terms of the German mark, euro, or another currency.

The central idea of a currency board is to eliminate exchange-rate volatility and hyperinflation as threats to the economy. The experiences in Argentina and elsewhere have shown that this system can work effectively. However, it is crucial to recognize that a currency board is not a cure-all. It must be combined with an effective economic team and with a broader program that includes fiscal discipline, legal reforms, and improvements in the banking system.

MIXED BLESSING. A currency board is guaranteed to succeed at fixing the exchange rate if the central bank begins with international reserves at least equal to its liabilities—mainly currency and bank deposits—and if these reserves are dedicated to conversions between the domestic and foreign currency at a specified rate. The setup does rule out an independent monetary policy. Some economists view this as a shortcoming, although an independent monetary policy is, at best, a mixed blessing. In fact, a strong point of a currency board is that it prevents the central bank from financing the government (directly or by purchasing public debt), bailing out banks, providing credit to favored industries, propping up stocks, and so on.

The Russian government would foster the idea that the ruble was as good as the dollar by not restricting the uses of foreign currency as media of exchange or stores of value. Since tax collections and other items would remain ruble-denominated, the domestic cur-

rency could eventually emerge as the preferred means of payment for most transactions. In this happy state, people would choose to exchange their U.S. currency for ruble-denominated assets.

The currency-board period has to be preceded by a period of floating rates in which the value of the ruble is determined by the market. This market value would depend on expectations about future policies, notably on whether Russia was thought to be moving toward a period of uncontrolled money creation and hyperinflation. The unfortunate fact is that some interval of money creation—to clear the decks by paying wage and pension arrears and to cover some bank deposits—is inevitable. Roughly speaking, the monetary base has to rise by 50% to finance these items. This amount looks large but is actually small in relation to the rises in the ruble-dollar exchange rate and the price level that have already happened.

USEFUL OPTION. The key matter is whether the impending money creation is temporary—a drunkard's last drink that precedes the implementation of lasting reform—or a permanent policy that goes along with hyperinflation and the return to a statist economic regime. The reform choice is by no means assured but its probability would be raised by the presentation of a coherent economic plan which includes a currency board. Also central is a budget program that involves improved tax collections, reductions in tax rates in areas where collections are minimal, and cuts in public outlays at the federal and regional levels. Another good idea would be the conversion of the domestic and foreign public debts—practically in default now—into long-term, dollar-denominated bonds.

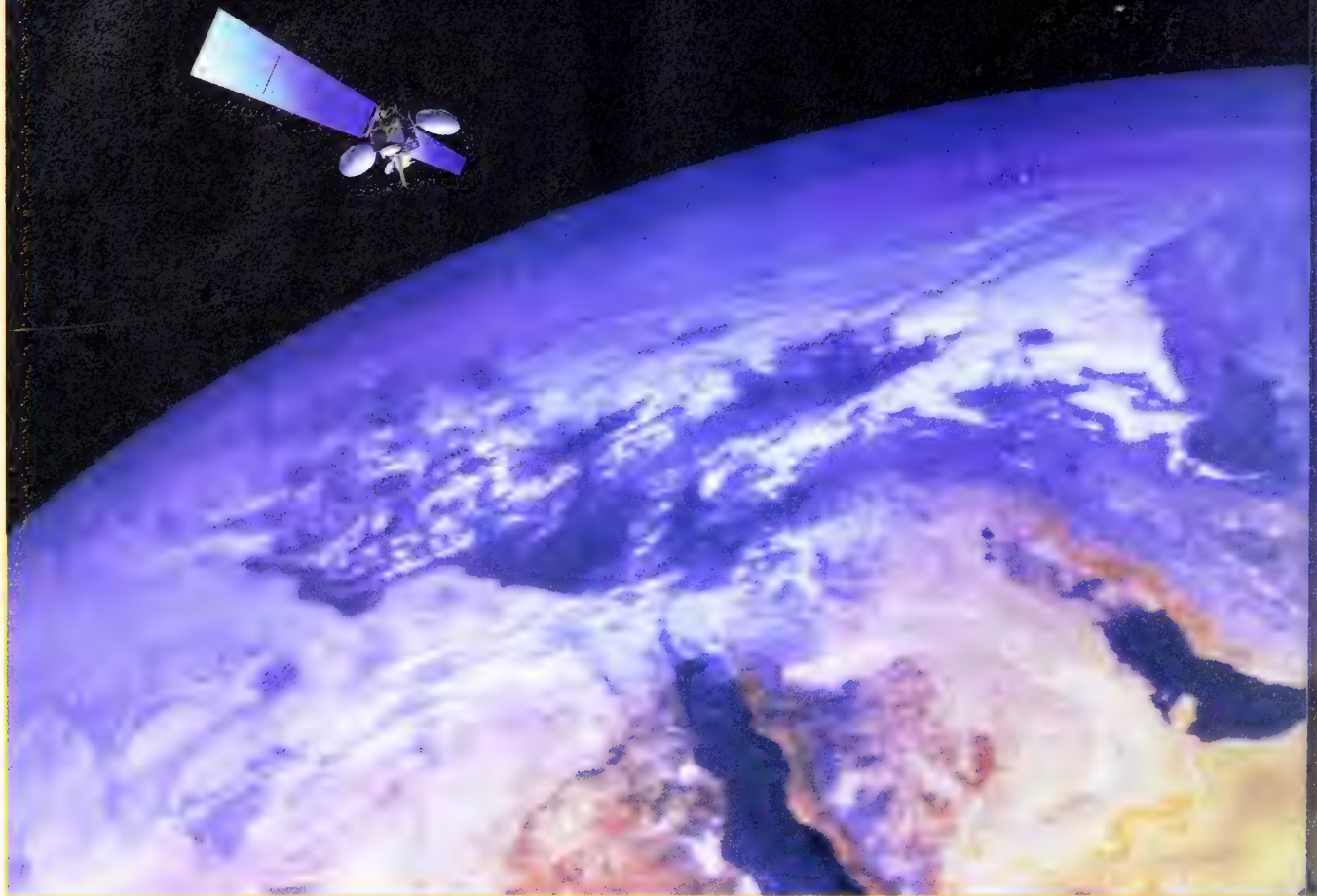
The implementation of a currency board also provides the International Monetary Fund with a useful lending option. Instead of providing funds to Russia that basically disappear and are used as excuses not to carry out budget reforms, the IMF could lend only for the purpose of strengthening the currency board's reserves. To begin, something like \$5 billion to \$10 billion would be needed to raise international reserves from \$12 billion to \$17 billion to the required level, which I estimate at around \$20 billion. With this policy, the IMF would not only be doing something economically useful but also be raising the probability that its old loans would be repaid.

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu).

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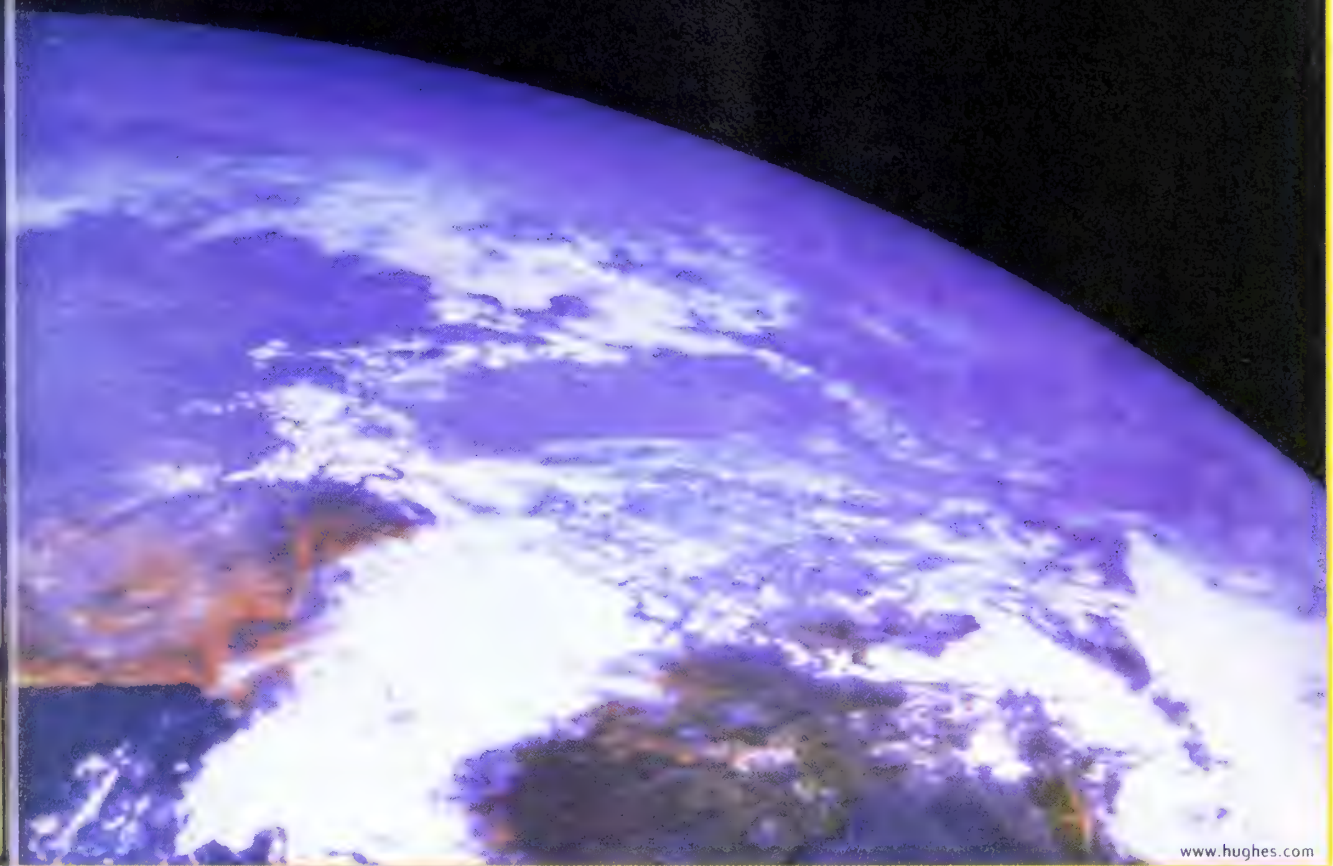
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BY GENE KORETZ

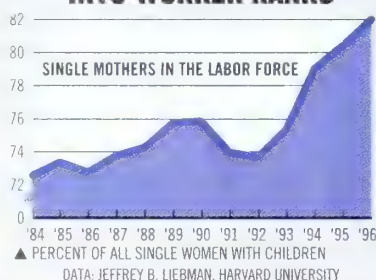
A TAX CREDIT THAT DELIVERS

Efficient aid for the working poor

Ronald Reagan called it the best anti-poverty and job creation measure to come out of Congress, and Clinton Administration officials cite its expansion as one of their major achievements. Today the earned income tax credit (EITC) benefits some 19 million working families at a cost of \$28 billion.

Is it worth it? Advocates claim the credit—which provides cash to low-wage earners with children—reduces poverty and income inequality without the hefty

SINGLE MOMS HAVE SURGED INTO WORKER RANKS



administrative costs or work disincentive effects of welfare. Businesses like it because it rewards workers without raising employer costs and thus encourages both job-seeking and hiring. But fiscal critics worry about its high cost and susceptibility to fraud.

In a recent study, Harvard University economist Jeffrey B. Liebman assesses the EITC's track record. Because it is keyed to earnings, and many poor households have had little or no earnings or fail to apply, he finds that the credit has helped more near-poor families than families under the poverty line. In the process, it has mitigated the effect of rising income inequality in the economy, offsetting nearly a third of the 14% drop in income share suffered by the lowest fifth of households with children over the past two decades.

Liebman also finds that the tax credit has substantially boosted work activity by single mothers. Their labor-force participation rate has risen by about 10 percentage points since 1984 (chart), mirroring almost exactly a decline in the number of such women on welfare who do no work. Meanwhile, labor-force

participation by single women without children (who qualify for a negligible tax credit if they work, compared with as much as \$3,656 for single working moms) has actually declined.

One concern about the EITC is that many low-wage workers face a huge marginal tax of more than 50% as it is phased out at earnings levels over \$12,000—that is, the combined effects of losing the credit and paying payroll and income taxes mean that workers may take home less than half of each additional dollar earned. But while economic theory suggests that such workers will reduce their work effort when they reach the phaseout range, Liebman finds no evidence this actually occurs. A possible explanation: Many beneficiaries have little awareness of how the tax credit works.

What of charges that the tax credit program is plagued by fraud? Liebman estimates that rule changes and closer monitoring by the Internal Revenue Service have reduced the incidence of noncompliance to a level comparable to that found in the income-tax system in general. Moreover, most ineligible recipients have low incomes, and close to half of erroneous claims appear inadvertent rather than fraudulent.

Thus, Liebman concludes, the EITC seems a reasonably effective way to accomplish several goals: reducing earnings inequality, rewarding low-income workers, and—perhaps most important in light of welfare reform—encouraging welfare recipients to join the workforce.

DEFLATION: IS THE FED PREPARED?

Prices may plummet in a recession

With consumer prices up less than 2% over the past year, it's hardly news that we now live in a relatively inflation-free environment. What many people seem to be ignoring, however, is the potential for significant deflation if a recession hits, says James W. Paulsen, chief investment officer of Norwest Investment Management Inc.

Paulsen believes that prices have been held down not only by excess capacity overseas but by unusually robust capacity expansion in the U.S. To show how strongly domestic supply has grown relative to demand, he divides the manufacturing capacity index by real GDP, which is a proxy for basic demand. Whereas in previous business cycles this ratio has risen only during downturns, it has taken off in recent years and is now

higher than the levels reached in four of the past five recessions.

This has occurred, says Paulsen, because much of the current expansion has been fueled by investment in capacity, with consumption assuming a smaller role than in past upturns. As a result, domestic supply is now at record level relative to demand—a state reached previously only when demand evaporated in the depths of recessions.

The upshot, Paulsen argues, is that a recession today would exert far more severe downward pressure on prices than in past contractions, when the emergence of excess supply acted simply to cool inflation. "What the Federal Reserve should be thinking about as it considers easing," he says, "is the unprecedented risk of escalating deflation if the economy slips into recession."

THE IFFY OUTLOOK FOR GOLD

Demand for gold jewelry is slowing

Once upon a time, investors turned to gold to hedge inflation or currency risks. No more. Rather, current turbulence in global financial markets may herald further weakness in gold prices, warns Kevin A. Crisp of J.P. Morgan Securities in London.

The reason: With central banks selling gold reserves in recent years and inflationary pressures waning, consumer demand for gold jewelry—particularly in developing Asia—had emerged as perhaps the major prop of gold prices in dollar terms. Now, however, deep recessions in Asia have inspired distress selling and undercut consumer purchases, even as the collapse of many Asian currencies has led to prohibitively high prices in local markets.

In light of growing woes in the developing world and an anticipated global slowdown, the prospects for continued rapid growth in private-sector demand for gold jewelry look iffy. Add the lack of investor interest in the metal as an inflation hedge, and the possibility that prices could test 20-year lows by year's end looks decidedly realistic.

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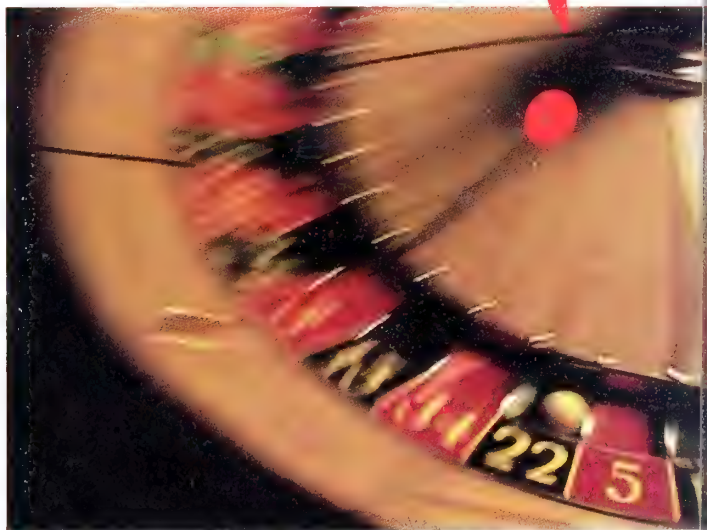
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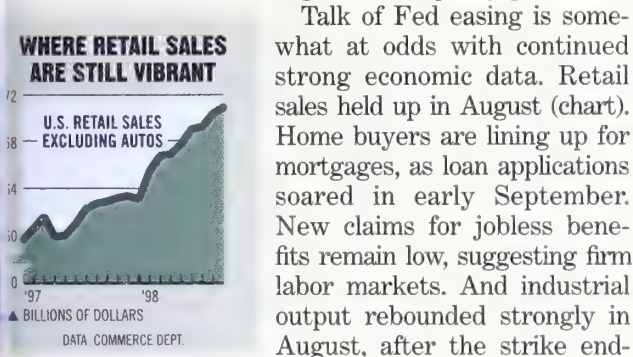
Y JAMES C. COOPER & KATHLEEN MADIGAN

THE BETTING NOW S FOR A RATE CUT

The snag: Solid domestic demand doesn't justify such a move

U.S. ECONOMY About-face! Economists' expectations for Federal Reserve policy have turned 180 degrees in recent weeks. A slew of analysts have not only downgraded their outlooks for economic growth, but they are also projecting that the Fed will cut interest rates some time between the Sept. 15 policy meeting and early next year. For most, the only questions left are "when" and "how much."

It's not just the economists betting on lower rates. The credit markets have priced a substantial Fed easing into the value of securities. The shift in market opinion has been fueled by three things: the gravity of world financial stress, its fallout on U.S. markets and its implication for slower U.S. growth, and recent words by Fed Chairman Alan Greenspan, who revealed on Sept. 4 a general shift in the Fed's thinking about its policy priorities.



at General Motors Corp. To be sure, the resilience of the U.S. economy in the face of global distress has been its most remarkable feature so far this year. However, economists and Wall Streeters, as well as Fed policymakers, know that current data has been rendered "old news" by recent events. Now, the focus is the future, at a time when prospects are dimming. In fact, on Sept. 16, Greenspan noted "the first signs of erosion around the edges" of the U.S. economy (page 44).

EVEN THE ECONOMY'S TRACK RECORD, the Fed will undoubtedly move cautiously, taking care not to underestimate the power of domestic demand, especially with labor markets still very tight. Indeed, in his much-anticipated Congressional testimony on Sept. 16, Greenspan's prepared remarks offered few new insights to his thinking on a possible U.S. rate cut. He also appeared to scotch recent talk about a broad rate reduction among large industrialized nations, saying that "at the

moment there is no endeavor to coordinate interest rates cuts."

Meanwhile, the financial markets are telling the Fed to ease. The Treasury's three-month bill and the two-year note both are yielding about 4.7% as of Sept. 15, while the Fed's overnight policy rate remains at 5.5%. That spread says that the market expects eventually to see at least three-quarters of a percentage point of easing. With bourses around the world, including those in the U.S., so fragile now, the Fed may be more attentive to market sentiment than usual. The Fed knows that if it frustrates these expectations of lower rates, the markets could react negatively.

In addition, several policy models are signaling an easing. The popular Taylor Rule, which relates economic growth and inflation to the Fed's policy rate, is beginning to call for a rate cut for the first time in two years. If economic growth slips below its 2½% trend rate, as is increasingly expected, the model's easing recommendation will strengthen. The Taylor Rule has tracked Fed policy in the 1990s fairly well.

Despite some forecasts of a cut as early as the Fed's Sept. 29 meeting, the more likely action will be a formal vote to shift the central bank's policy bias from neutral to easing. Greenspan has already signaled that the Fed moved its so-called intermeeting policy directive from tightening to neutral at the Aug. 19 meeting. Such a further shift does not guarantee a rate cut, but it would cock the Fed's pistol, and possibly even give Greenspan the authority to fire away at any time.

NOT ALL BOND RALLIES ARE CREATED EQUAL

SECURITY	YIELD ON JULY 17	SEPT. 15	POINT CHANGE
30-YEAR TREASURY	5.73	5.23	-0.50
AAA-RATED CORPORATE	6.61	6.43	-0.18
BAA-RATED CORPORATE	7.19	7.11	-0.08
BB-RATED CORPORATE	8.98	9.89	+0.91

DATA: STANDARD & POOR'S DRI, BLOOMBERG FINANCIAL MARKETS

CLEARLY, THE NEW RESTRICTIVENESS in global and U.S. financial conditions is a key feature of the downshift in U.S. growth prospects. Slower world growth will continue to dent U.S. exports, and weaker stock prices will clip consumer outlays and capital spending. But what has gone largely unnoticed is the widening of credit spreads in the U.S., a development that Greenspan regards as usually a bad sign for the economy (table). Despite the huge rally in the Treasury bond market, some corporate borrowers are getting stiffed.

For example, the Treasury rally had dropped the yield on the 30-year bond to as low as 5.13% on Sept. 11, be-

ERIC HOFFMAN, BW

fore backing up recently to about 5.25%. But while Treasury yields have fallen 50 basis points since mid-July, top-quality AAA-rated corporate bonds have declined less than 20 basis points, to 6.43%. Meanwhile, yields on medium-grade corporates have not declined at all, and those for poorer quality borrowers have increased sharply.

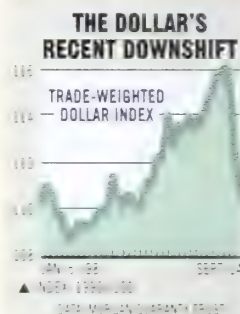
The Fed is aware that any move to cut rates could come at a cost of higher U.S. inflation. In particular, any Fed easing would invite a sharp weakening of the dollar, especially if the move is not in conjunction with other large central banks. Remarks by top officials at the Bundesbank on Sept. 15 strongly suggest that Germany has no desire to cut rates. A weaker dollar would be a plus for currencies and financial conditions outside U.S. borders, but the dollar's 25% trade-weighted surge in the past three years also has supplied a key restraint on U.S. inflation. This is the chief reason the Fed will move cautiously. The dollar has already dipped broadly just on the expectation of a U.S. rate cut (chart).

THE SOLID TONE OF DOMESTIC DEMAND hardly justifies a rate cut. Retail sales rose 0.2% in August, and excluding car-buying, sales were up 0.3%. The retail data suggest that overall real consumer spending in the third quarter is rising at an annual rate of about 2%. While that's a sharp slowdown from the booming 6% pace in the first half, most of the change can be ac-

counted for by a drop in auto sales prompted by the GM strike and the expiration of generous spring sales incentives, which caused sales to surge back then.

Foreign demand is a different story, however. Industrial production at manufacturers, utilities, and mines jumped 1.7% in August, after falling 1.1% in June and 0.4% in July. Output in the manufacturing sector alone surged 2% in August, but here again, the auto strike is distorting the data. Excluding motor vehicles and parts, factory output rose a scant 0.1%, and for the third quarter, it is on a track to post little, if any, growth for the first time since the 1990-91 recession. That weakness primarily reflects sagging exports and more import competition.

Trying to second-guess Greenspan & Co. is always a risky business. Clearly, domestic economic conditions do not argue strongly for a rate reduction, but based on his latest comments, Greenspan's Brave New World thinking may well have altered the way the Fed chief views U.S. policy in a global economy. On Sept. 16, he said the monetary policy "cannot be done without advertence to the world economy." For now, the markets have made their bets. The next move is up to the Fed.



AUSTRALIA

AVOIDING THE ASIAN FLU—SO FAR

While much of the Pacific Rim is in recession, Australia appears stable. Growth is slowing, but the latest data on business confidence, consumer spending, and job growth suggest that the Aussie economy will keep expanding into 1999. Perhaps that's why Prime Minister John Howard has called a general election for Oct. 3—six months early.

Real gross domestic product grew a larger-than-expected 0.9% in the second quarter from the first. That puts GDP 3.9% above its year-ago level, aided by a surge of consumer spending and hefty inventory building. Strong domestic demand will offset some of the drag coming from trade.

Business confidence rose in the third quarter, with better outlooks for exports, orders, and investment plans. Consumer confidence increased 1.3% in August, while retail spending in July rose 2.6%.

Consumers can increase their spending because job prospects are improving. Companies added 13,200 jobs in August, and hiring is growing 2.7% from the year before, the fastest rate in almost three years (chart). The jobless rate, though, remains stubbornly above 8%, as it has for almost all of the past eight years.

But the falloff in Asian demand for Australian exports, especially commodities, will slow the econo-

my later on. On Sept. 8, the Treasury Dept. said that real GDP growth will ease to 2.75% over the next year, down from its May forecast of 3%. The slowdown could cut the expected fiscal surplus to zero, but it will also hold 1999 inflation below 2%.

An outlook of steady growth and quiescent inflation is why the Reserve Bank of Australia has signaled a "wait and see" monetary policy. "Output is growing at a moderate but below-trend pace," said the RBA's quarterly economic report. The RBA's key concern now is the Australian dollar, which has plummeted 22% against its U.S. counterpart. The Aussie dollar's slide and falling commodity prices are significant blows to the economy. But given the Pacific turmoil, Australia's situation could be much worse.

JOB GROWTH IS PICKING UP STEAM



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READY: The Clintons, Rubin, and Sperling

CLINTON'S

His global rescue plan is short

Back in June, Bill Clinton's political instinct told him it was time for the U.S. to take action in solving the spreading global economic crisis. His chief economic adviser, Treasury Secretary Robert Rubin, disagreed, arguing that it would be risky to take the lead before a credible plan could be prepared.

Rubin may have been right. But by the time Clinton took to the podium at the Council on Foreign Relations on Sept. 14 to announce his plan for a coordinated assault on the global economic disease, the world had changed. The contagion had spread from Asia, to Russia, and finally to Latin America—leaving in its wake bankrupt companies, exasperated investors, and decimated stock markets. And the Bill Clinton who unveiled a seven-point plan at the Council on Foreign Relations was scrambling to restart a Presidency crippled by scandal (page 42).

Is it too late for Clinton to lead the Group of Seven industrialized nations' effort to meet what he called "the biggest financial challenge facing the world in a half-century"? And is the plan he prescribes workable?

Global markets, yearning for some leadership in dealing with the crisis, halted their free fall, at least temporarily, in the afterglow of Clinton's speech. Brazilian President Fernando Henrique Cardoso and Mexican President Ernesto

Zedillo Ponce de León phoned Clinton to thank him. Zedillo's message: "We felt all alone. It's great to know the G-7 is focusing on us."

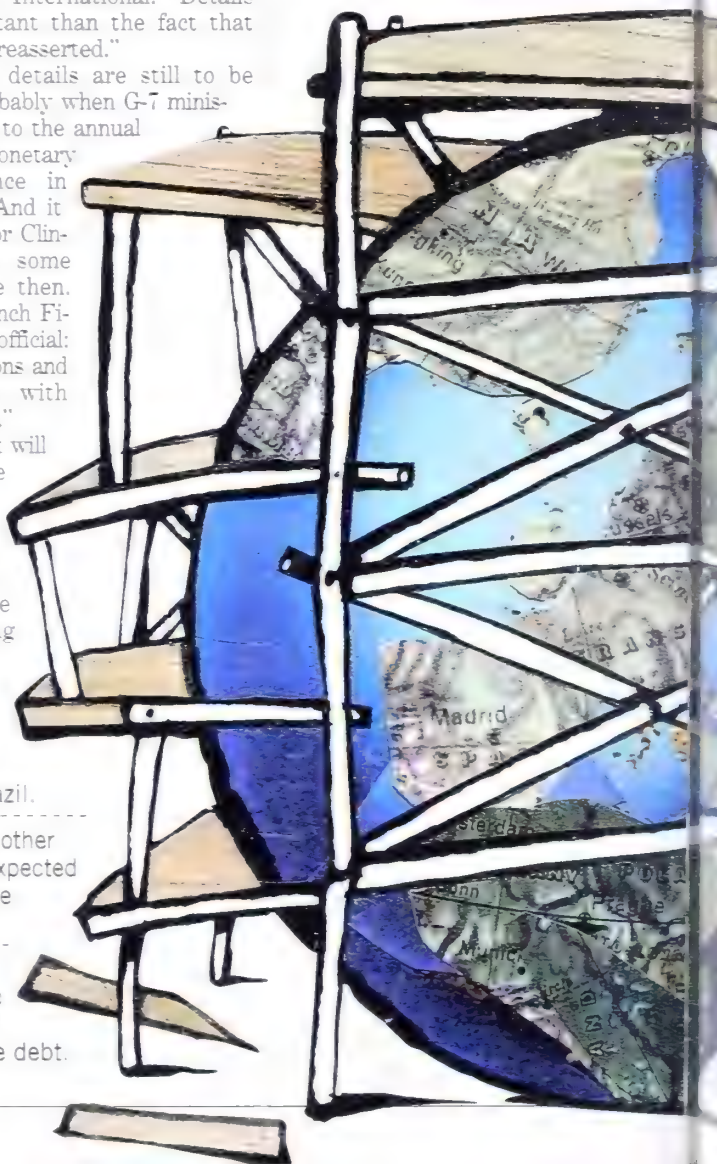
Indeed, in that respect, the speech is a milestone: the first time any of the world's top leaders has acknowledged the enormity of the task ahead and offered a blueprint of what must be done. Notes Robert D. Hormats, vice-chairman of Goldman Sachs International: "Details are less important than the fact that leadership was reasserted."

Most of the details are still to be worked out, probably when G-7 ministers meet prior to the annual International Monetary Fund conference in early October. And it will be critical for Clinton to show some progress before then. But, says a French Finance Ministry official: "It gives directions and we all agree with those directions."

The first task will be to rally the world's rich nations behind rate cuts that will keep growth going and give the emerging

economies breathing room. Further out, Clinton acknowledges the need for a new post-IMF global financial architecture which many in Europe and Asia have called for. Says the French official: "The whole architecture needs to be reviewed."

While none of the big countries will endorse currency and capital controls, they are likely to focus on stricter supervision of short-term bank deposits



A 7-Point Program to Mount a G-7 Aid Mission for Emerging Markets

ASSERT LEADERSHIP By letting markets know someone's taking charge, Clinton and the G-7 hope to stop the plunge in markets such as Brazil.

SPUR GROWTH The Fed and other central banks are now widely expected to cut rates, which will stem the flight of capital to the West.

WORK OUT DEBTS A Treasury team is headed for Asia to search for ways to consolidate and restructure Asian corporate debt.

CALL TO ARMS

sacrifices, but asserting leadership may be enough for now

eventually, this would mean establishing some sort of global Federal Reserve—a watchdog for the banks and a deterrent to the kinds of capital controls at countries like Russia and Malaysia have recently implemented.

To keep the contagion from spreading America's doorstep, Clinton wants to build a firewall around Latin America. Behind the scenes, the U.S. and the cash-strapped IMF are try-

ing to cobble together emergency funds for Brazil if its markets collapse.

Clinton's plan calls for the G-7 to restructure the debts of troubled Asian companies and a rollover of Russia's long-term debt. Clinton also wants the World Bank to double its poverty relief aid to the crisis countries. Meanwhile, the State Dept. is considering sending food to Russia before the snow falls. And the ExIm Bank is negotiating \$4.25 billion in loan guarantees to Korea, Thailand, and Indonesia so their companies can buy U.S. raw materials and equipment needed to

keep their factories running. ExIm Chairman James A. Harmon is headed for Latin America to cut similar deals.

That adds up to the first comprehensive fix-it plan for the global economy. The G-7 nations issued a joint statement in support of Clinton's proposals on Sept. 14. But getting the G-7 to work together to carry it out won't be easy. For example, even after a week of furious negotiations among finance ministers and central bankers from the G-7 nations before Clinton's speech, there was no agreement on a coordinated rate cut. German Bundesbank President Hans Tietmeyer bristled at the notion. And Bank of England Governor Eddie George warned that a coordinated rate cut would be "going too far." On Sept. 16, Fed Reserve Chairman Alan Greenspan told Congress: "At the moment, there is no endeavor to coordinate interest rates."

That's a bad sign. The rate cut itself may not be the most important step, but it is the easiest—and a powerful signal to financial markets that global cooperation is possible.

Greenspan and European central bankers face substantial domestic obstacles to pulling off a simultaneous rate cut. In the U.S., labor markets remain tight and real wages are rising. European bankers are leery of attempting a cut when they're trying to coordinate rates in advance of the euro. That in-

There's a deep suspicion among Republicans that the plan to save the world economy is more show than substance

SOCIAL SAFETY NET

Clinton wants the World Bank to double its aid to Asia's crisis countries. Also, calls for the U.S. to step up food and other humanitarian aid, especially to Indonesia.

FINANCIAL SAFETY NET With the IMF's cash running low, Clinton wants the agency to consider using a \$15 billion emergency fund if Brazil's markets start to crater

EXPORT LENDING The Export-Import Bank is preparing \$4.25 billion in short- and medium-term financing to help Korean, Thai, and Indonesian firms buy the American equipment and materials they need to operate. ExIm's next stop: Latin America.

FIX THE PLUMBING Clinton sets a yearend deadline for finance and central bank officials to propose new ways to predict, prevent, and manage currency and financial crises.



"If Clinton gives a speech but can't get money from Congress"

cludes a plan for Germany to raise rather than lower. White House officials hope that Greenspan's prestige will ultimately persuade European central banks to match any Fed easing. "A lot of us here think it wouldn't be so bad if European [monetary] policy wasn't quite so tight," says one Clinton adviser.

Clinton's domestic problems won't help. Some Republicans are already attacking the Sept. 14 initiative as simply a convenient way to change the topic from Mon-

ica. "It's one thing to give a speech. It's another thing to act," says Senator Robert F. Bennett (R-Utah).

Republican cooperation will be essential. Even before the Starr report landed, Republicans were resisting Clinton's pleas for \$18 billion in emergency funding for the IMF. Privately, Republican leaders opposed to further IMF funding concede that the money will likely be approved—but only at the last moment before Congress adjourns in October. If Congress

doesn't come around, the setback to his plan could be fatal. "If Clinton gives a speech but can't get money from Congress for the IMF, it will leave a very hollow feeling—almost worse than doing nothing," says Hormats. "The IMF money is a proxy for America's leadership in the world economy."

Another hurdle is Japan. It has resisted calls for an overhaul of its ailing banking system and tax cuts to stimulate its economy. But there are signs of progress.

CAPITAL CONTROLS: LIFELINE OR NOOSE?

When investments were gushing into developing countries in the mid-1990s, economists from Washington to Warsaw agreed that free-flowing capital was essential to global prosperity. But now that panic has set in and money is rushing right back out of the developing world, the buzz is different. There's growing interest among economists and policymakers in clamping down on capital flows so "hot money"—fast-moving institutional capital—can't wreak havoc on ill-prepared economies.

It's not exactly a fresh idea. In fact, capital controls were the norm around the world—even in the U.S.—until the 1960s and '70s. They lingered in France and Italy till the late '80s. China and India, among other nations, still use them. Malaysia reimposed them on Sept. 1.

What are capital controls? Generally, the term applies to any measure that limits cross-border investment. For example, some nations forbid citizens from owning assets such as stocks, bonds, or homes abroad. Others limit foreign ownership of domestic assets.

Capital controls require strict limits on currency conversion. To control outflows, for example, a company may have to convert any overseas earnings into local currency, rather than hold dollars, say. Citizens may be limited in how much money they can take out of the country on trips. To limit inflows, governments might tax interest payments on short-term deposits from overseas.

Developing countries often use controls to stem capital flight—when citi-

zens send savings abroad for higher returns instead of investing them at home. In theory, capital controls also let governments pursue economic policies appropriate to their internal conditions without worrying about the reactions of global investors. For instance, a country could jack up interest rates to squelch inflation without being deluged by foreign money seeking high yields—which would tend to exacerbate inflation. A country in recession could lower rates without having investors bail out.

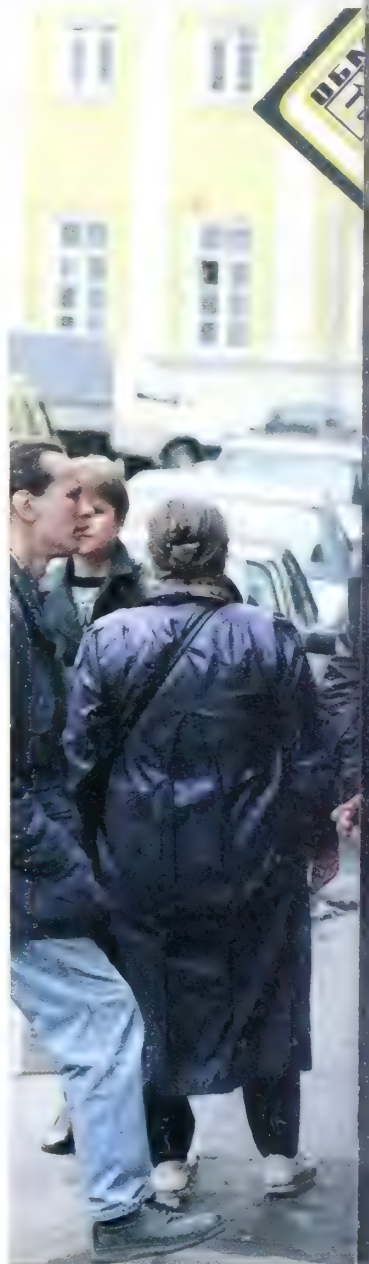
That, anyway, is the theory. In practice, most nations have abandoned capital controls because they haven't met expectations. Take India, which is sometimes held up as a country spared from turbulence by controls. The price of stability has been isolation and poverty. Controls haven't stopped rich Indians from moving money abroad—but have discouraged Western investors from bringing in money and technology. So India's government has begun lifting the controls and expects to finish the job by 2000. Economists who advocate controls elsewhere "are only echoing what India has practiced, with disastrous results, for the last 25 years,"

says Surjit Bhalla, a former World Bank economist who directs New Delhi-based investment advisory firm Oxus Fund Management.

Capital controls simply can't work well in a world of

RUBLE FRENZY

Controls can buy time to jump-start an economy, say advocates. But they also scare off investors



the IMF, it will leave a very hollow feeling"

Prime Minister Keizo Obuchi, set to meet Clinton on Sept. 22, recently signalled a readiness to consider nationalizing Japan's troubled Long Term Credit Bank.

Latin America may be the most pressing concern for the U.S. The IMF has at least \$25 billion in resources. But some analysts believe Brazil alone would require more than the \$50 billion the Treasury Dept. and IMF provided a smaller Mexican economy three years ago.

In Asia, the Administration's primary

goal is debt relief—an arduous and politically delicate process. The Asian debts are held by thousands of private companies, not by a handful of governments. Without debt relief, the Administration fears that nations that have faithfully followed the IMF austerity prescriptions will follow Malaysia, which has resorted to strict controls to protect its currency.

For now, Clinton is mobilizing his Administration to finally tackle a crisis he once dismissed as "a glitch in the road."

His aides have a long way to go to put flesh on the bones of a new bailout plan. But at least the U.S. is finally showing the leadership that the world has been seeking.

By Dean Foust and Mike McNamee in Washington, with bureau reports

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free trade and porous borders. If a country has an unattractive investment climate, investors will find ways to get money out—in their underwear, if need be. And investors will work just as hard to get money into a country that seems attractive, as Brazil discovered in the mid-1990s when it fought inflation with high interest rates.

One solution is to erect massive bureaucracies to crack down on illegal money flows. China, which does not allow its currency to be freely converted, on Sept.

are the kind of things that right-thinking people aren't supposed to like, but every once in a while they do some good."

Malaysia, for one, needs financial reforms before it can successfully absorb foreign investment. And "it's easier to do that sort of reform when you're in a stable environment," argues Stephen M. Taran, global head of sovereign research for Salomon Smith Barney and an adviser to Malaysia. Taran says capital controls will let Malaysia complete reforms quickly and reopen its doors to the foreign

HOW COUNTRIES CONTROL CAPITAL FLOWS

CONTROLS ON INFLOWS

- Make investors set aside part of incoming money in non-interest-bearing accounts
- Prevent foreigners from buying certain things, such as banks or real estate
- Use taxes to reduce how much incoming funds can earn on local investments

16 announced stepped-up policing of the thriving black market in currency.

Bureaucracies are usually no match for determined capital exporters, however. One trick is to cheat on invoices: An exporter who wants to invest abroad underbills foreign customers. They pay the full sum owed; the exporter hides the excess over the invoiced amount in foreign assets.

Advocates of capital controls acknowledge these drawbacks. But they argue that depressed Asian economies need to lower interest rates to get moving again, and the only way to do that is to wall off their capital markets—at least briefly—from the rest of the world. Says Eugene K. Galbraith, managing director at ABN Amro in Hong Kong: "Capital controls

CONTROLS ON OUTFLOWS

- Set foreign-exchange rates for trade different from those for investment
- Force exporters to sell foreign-currency earnings to an approved bank, which controls resale
- Lower the yield on foreign assets relative to domestic assets through taxes

capital it needs for long-term growth.

That remains to be seen. Meanwhile, Malaysia's controls have deeply frightened global investors because they amount to a financial Roach Motel: Money can get in, but it can't get out. Investors are more sympathetic to limits on the inflow of capital. Chile, the economic star of South America, requires a portion of incoming money to be parked in a non-interest-bearing account for a year. That limits the hot money coming in so there will be less capital flight later. Putting up a velvet rope to control admission is more inviting than putting bars on the windows to prevent escape.

By Peter Coy in New York, with Manjeet Kripalani in New Delhi and Mark Clifford in Hong Kong

By Pete Engardio

WHERE CAPITALISM ISN'T CAPITALISM

Back in 1988, several years before emerging-market mania gripped the West, a little-known economist from Kyoto University named Yoshihara Kunio published a book called *The Rise of Ersatz Capitalism in South-East Asia*. In it, Yoshihara concisely detailed the deep flaws that permeated the business cultures of Indonesia, Thailand, and Malaysia. Among them: The region's capitalists were obsessed with building family fiefdoms and amassing wealth based on personal contacts, rather than developing world-class industries.

Too bad Western investors didn't pay as much attention to Yoshihara's tract as they did to World Bank and brokerage reports touting the Asian miracle. They still might have pumped billions into Asia. But investors would have been more savvy about the risks—and less dumbfounded by the collapse in East Asia and the inability of the International Monetary Fund to fix the damage overnight.

Understanding the chasm between Western and Eastern versions of capitalism is just as important now as policymakers and investors try to make sense of the widening debate over globalization. Much of the current discussion centers on mechanics, such as whether it is prudent for developing countries to reimpose controls on currency inflows of foreign hot money.

FAMILY FIRST. The real battle is over much deeper issues. Contrary to Western norms, most Asian leaders think there is nothing wrong with using domestic financial institutions to prop up companies and projects of political allies. To Asian execs, their families' financial interests take precedence over those of shareholders—and unlike in the U.S., shareholders and regulators won't oppose them.

Even with all the celebration over the relentless march of the American way, Western-style capitalism and the rule of law that guarantees it never really took in Asia. Sure, the tri-



WIDE CHASM: *Western trappings, Eastern mores*

umphs were many: Governments greatly liberalized capital markets, foreign investment, and trade. But loans were still made on the basis of personal relationships. Companies focused on accumulating assets, not returning profits to investors. Securities laws seemed adequate, but regulators lacked the power to enforce them.

These practices live on, to the dismay of the IMF, World Bank, and Clinton Administration. Western officials concluded that Asia's downfall was its lack of honest data and institutions that could cope with massive private capital flows. Thus, "transparency" and "institution-building" be-

came globalization's buzzwords. The concept: Get governments to enact a slew of U.S.-style commercial laws, commit to wholesale bank restructuring, and train everyone from bankruptcy judges to bank examiners. Then, foreign investors would come back, snap up cheap assets, and put Asia on the road to recovery.

This Washington view of the world has proved naive. For one thing, with the memory of the hits they took earlier in Asia still fresh, foreign fund managers and bankers won't be easy to entice back. And while there have been some notable foreign takeovers, the price tags placed on Asian assets have been too steep to ignite any real fire sales. For Asians, corporate assets are familial—and national—jewels. So rather than see foreign carpetbaggers snare them, South Korean banks are letting overleveraged *chaebol* reshuffle assets among

themselves. In Japan, Toyota Motor Corp. is helping bail out a failing bank. And in Thailand, chemical companies and hotels are stiffing creditors, as bankruptcy cases languish.

So is it futile for the IMF to push reform? Certainly not. Among Asian leaders, there's broad consensus that institutions and business practices must be upgraded. What's misguided are Western expectations that reform will be accomplished quickly—and that new standards alone will transform Asia's business culture. Investors and lenders will return when there is clear evidence the underlying economies are poised to roar back. And perhaps next time around, fewer will be fooled by economies that look Western—but operate under Eastern rules.

CRONY CULTURE Leaders see nothing wrong with propping up companies of political allies

Engardio is a senior international news editor and an Asian specialist.

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WHAT MATTERS MORE THAN MONICA? THE ECONOMY

Americans are disgusted with President Clinton's alleged behavior. And most think his power will be greatly reduced because of the Lewinsky scandal. But according to a Harris Poll of 1,009 adults taken on Sept. 9-13, Americans still approve of the job Clinton is doing—65% give him pretty good or excellent ratings and 82% be-



lieve the media have overplayed the Lewinsky affair. What worries Americans is the prospect of Asian contagion. Some 62% say the international crisis is very serious, and 70% believe the U.S. hasn't yet seen the worst of the fallout. Still, 82% believe the economy will be at least as strong as it is currently in a year.

RESIGNATION

Do you think President Clinton should resign or continue as President until his term ends?

Should resign31% Don't know2%
Should not resign66%

THE SCANDAL

Do you agree or disagree with the following statements:

AGREE DISAGREE DON'T KNOW

- A. I am disgusted by what I believe has been the President's behavior with women59%.....37%.....3%
- B. The media have given far too much attention to the Monica Lewinsky affair82%.....17%.....1%
- C. Kenneth Starr, the special prosecutor, is just out to get the President, whatever it takes, fair or unfair56%.....41%.....3%
- D. In judging President Clinton, we should focus on how the country is doing and his policies, not on his private life73%.....24%.....2%
- E. It will be difficult to believe anything the President may say in the future55%.....43%.....1%
- F. Even though he lied, the President should not be forced out of the Presidency unless he has committed a serious criminal offense72%.....26%.....1%

POWER DRAIN

If President Clinton continues as President to the end of his term in January, 2001, do you think he will still have a lot of power or do you think his power will have been greatly reduced because of the Lewinsky affair?

Continue to have a lot of power....35% Don't know.....2%
Power greatly reduced62%

POLITICAL FALLOUT

How much do you think the Lewinsky affair will help the Republicans and harm the Democrats in this November's congressional election—a lot, some, or not at all?

A lot27% Not at all.....20%
Some51% Don't know1%

ECONOMIC OUTLOOK

Over the next 12 months, do you think the U.S. economy will improve, worsen, or stay about the same?

SEPT. 1998 SEPT. 1997

SEPT. 1998 SEPT. 1997

Improve ..18%.....29% Stay about the same....64%.....49%
Worsen ... 17%.....18% Don't know1%.....4%

Some categories do not total 100% because of rounding or refusal to respond.

POCKETBOOK ISSUES

Where will you and your family be financially a year from now?

SEPT. 1998 SEPT. 1997

SEPT. 1998 SEPT. 1997

Better off36%.....50% Worse off9%.....10%
The same.....55%.....36% Don't know.....1%.....4%

GLOBAL CRISES

Many countries in Asia, and also Russia, are in a financial crisis. How serious do you think this crisis is?

Very serious62% Not at all serious2%
Somewhat serious.....32% Don't know.....1%
Not very serious3%

CONTAGION FACTOR

How much do you think that the Asian and international financial crisis will damage the American economy?

A lot23% Not at all.....6%
Some69% Don't know.....2%

PROGNOSIS

The international financial crisis has already done some damage to the U.S. economy and stock market. Do you think the worst for the U.S. is over or that the worst is still to come?

The worst is over.....27% Don't know.....3%
Worst is still to come ..70%

RECESSION

How likely do you think it is that the U.S. economy will go into a serious recession in the next two years?

Very likely16% Not at all likely9%
Somewhat likely.....37% Don't know.....1%
Not very likely37%

CONSUMER SPENDING

In light of the market correction, will your family spend more, less, or about the same compared to a year ago?

More.....32% Less.....13% About the same55%

INVESTMENT PLANS

Will your family invest more, less, or about as much of your money in stocks compared to a year ago?

More.....11% Don't know.....4%
Less.....18% About the same64%

EDITED BY KEITH H. HAMMONDS

Survey of 1,009 adults conducted Sept. 9-13, 1998, by Louis Harris & Associates Inc. Year-ago poll of 1,002 adults conducted Sept. 17-21, 1997.

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FEISTY: Clinton is desperate to appear Presidential

WASHINGTON

CAN CLINTON HOLD THE CENTER?

It won't be easy—particularly if the GOP gains in November

In a packed auditorium on Sept. 14, a glittering crowd of high-powered business leaders, bankers, academics, and media types saw the return of the old Bill Clinton. Gone was the gnawed-lip pose of abject contrition, an expression Americans have come to know well amid the Monica Lewinsky scandal. Regained was the earnest voice of the conciliator and determined gaze of a global leader. For 34 minutes, the audience at the Council on Foreign Relations in New York saw a President at the top of his game and, if his remarks were to be believed, on top of the world again.

It is a vision the White House hopes to project again and again in coming weeks to counter the frenzy fueled by Independent Counsel Kenneth W. Starr's report on Presidential misconduct. Buoyed by polls that show two-thirds of Americans approve of Clinton's job performance, White House strategists know that the appearance of a functional Clinton Presidency is crucial to his survival.

But is a revival of the feisty, factoid-spouting Clinton possible? Or has scandal so undermined his moral authority—and political power—that he'll be unable to make a dent in the national agenda?

For much of his tenure, Clinton dom-

inated the middle ground, carving out compromises and artfully blending Democrats' legislative compassion with Republicans' steely desire for fiscal restraint. Now, "his ability to command the center is weakened," says Samuel Popkin, a University of California at San Diego political scientist. Adds a Democratic Hill aide: "I don't think Bill's going to be doing much triangulating [between left and right] anymore. He'll be trying to make people happy."

That could mean a different path for U.S. policy. With Clinton in eclipse, Con-

gress could wind up in perpetual deadlock as liberals and conservatives battle for supremacy. Democrats will likely push left, demanding that the President stow any talk about "the sensible center." Translation: a stronger push for measures such as reform of managed care and greater resistance to initiatives such as privatizing Social Security.

Republicans, mindful that Clinton's escapades have religious conservatives in a fury, will be less inclined to compromise. "Clinton is the Antichrist to the right," says one Clintonite. "New Democratic just got a lot harder."

The prospect of prolonged partisan head-banging troubles many executives. Says James W. Breyer, managing partner at Accel Partners, a Palo Alto (Calif.) venture-capital firm: "The crisis has hindered [Clinton's] ability to [make] economic policy." David Wysch, chief economist for Standard & Poor's DRI, fears policy paralysis during lengthy impeachment process: "This could be going on for months at a time when the global economy is falling apart."

On the other hand, business leaders point out that the most important economic policy players are still in the game. "The U.S. is in the fortunate position of having [Federal Reserve Chairman Alan] Greenspan and [Treasury Secretary Robert E.] Rubin," says General Motors Corp. Chairman Jack Smith. "There's tremendous confidence in the U.S. by the business and financial community."

Still, there are some jobs only the President can do. And Clinton's immediate task is navigating the next few weeks, when Republicans send him bill

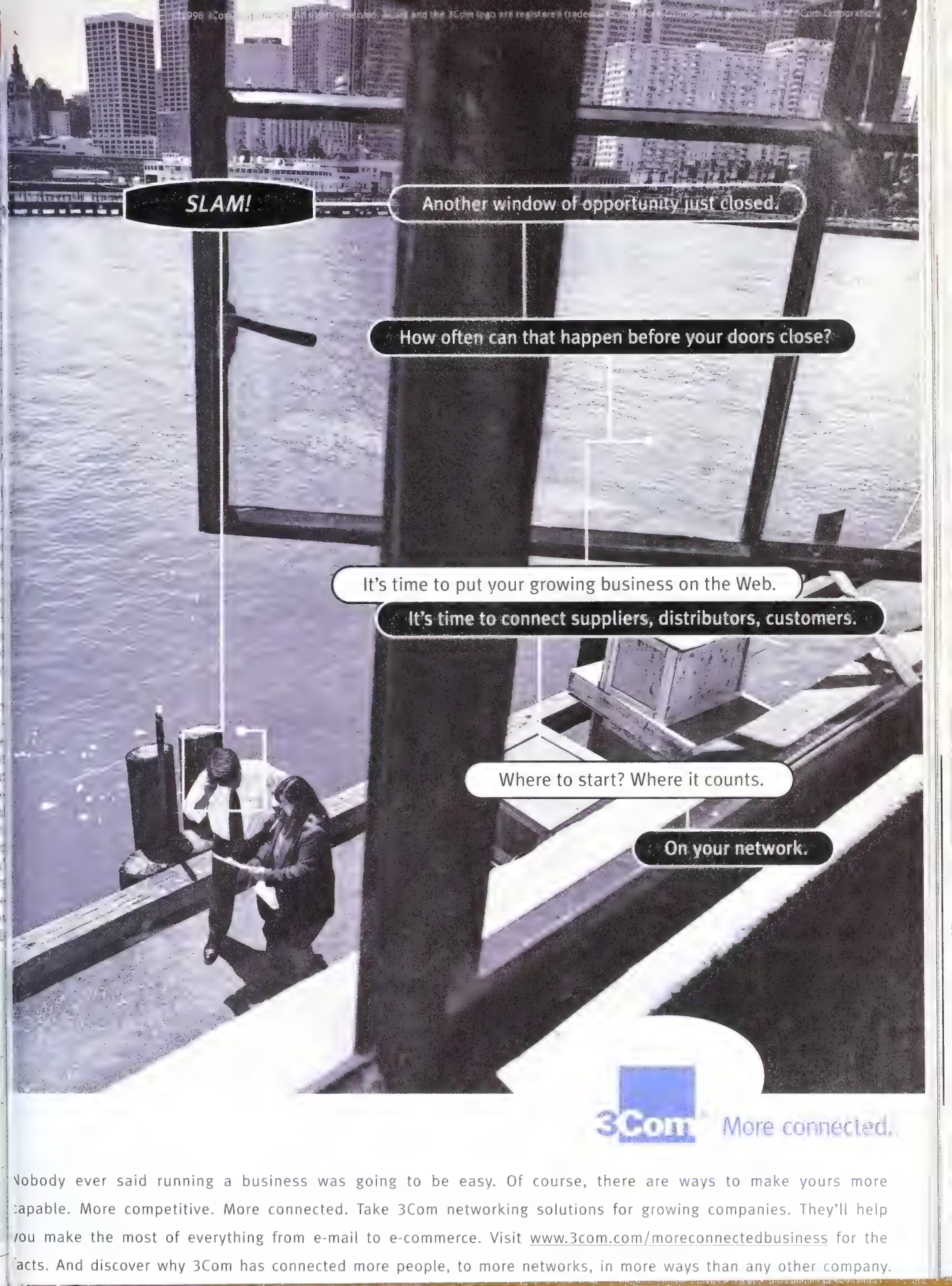
BACKED INTO A CORNER

TAX CUTS Clinton is set to veto Republicans' \$80 billion tax cut. Normally, he'd follow up with a compromise. But with Democratic liberals crying "No deal," the Prez may have to stand firm.

SOCIAL SECURITY Once Clinton's capstone second-term issue, reform looks less likely—a victim of vanishing bipartisanship.

TRADE A weakened President will be forced to accept more Republican conditions on IMF aid. And if the new Congress has more GOP populists, any trade initiatives will be difficult.

SOCIAL ISSUES Clinton could win short-term battles over abortion restrictions and curbs on environmental regulation. But come '99, Republicans may have the votes to nail legislation sought by the Religious Right.



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to fund federal agencies. To fire up the Right for November, they'll attach symbolic proposals, such as curbs on environmental and job-safety rules. After a round of vetoes, GOP leaders concede they'll relent to avoid the kind of disastrous government shutdowns they provoked in 1995 and 1996.

LAME OR DEAD? Another game of chicken looms over tax policy. Congress is set to enact a five-year, \$80 billion tax cut. The centerpiece: a smidgen of relief for two-earner married couples. Democrats oppose the move, preferring to use the surplus to shore up Social Security. To buttress support within his party, the President may have to shelve his impulse to compromise with the GOP and veto a tax cut this year. Next year, Republicans are expected to come back with a plan for a 10% rate cut.

By then, Clinton could be all but irrelevant. If Republicans win big on Nov. 3 or he is mired in impeachment hearings, "he goes from lame duck to dead duck," says GOP adviser Ed Gillespie.

And Social Security reform, which Clinton once thought would seal his place in history, likely goes nowhere. He will still seek a sweeping overhaul. But with doubts about privatization sown by the stock market's tumble, he won't bring many Democratic doubters along. Corporate lobbyists also suspect that any hope for trade liberalization—including fast-track negotiating power—has evaporated until after the 2000 elections. Says Representative James P. Moran (D-Va.): "There's a reluctance to give the guy [negotiating authority] when you are considering whether he should be impeached."

Clinton still hopes to be saved by a formula that has worked before: Republicans overstep and stir public backlash. "It will be a serious mistake for Congress to pick a fight over issues like education and the environment," warns White House policy adviser Bruce Reed. "They'll blink in the end." Adds Democratic strategist Tony Coelho: "His biggest advantage is the Republican right. Time and again, they overreach."

Not this time, Republicans vow. "Look at Newt Gingrich," crows a party elder. "He's been restrained, like he's on reverse Viagra." True. But if discipline among Newt's troops dissolves—Gingrich himself heated up debate Sept. 16, calling Clinton a misogynist—GOP leaders worry that, once again, Clinton could dance out of their grasp.

By Lee Walczak, Richard S. Dunham, and Amy Borrus in Washington with bureau reports



THE ECONOMY

ONE FRIEND CLINTON CAN COUNT ON: THE EXPANSION

It's withstanding stock market gyrations and troubles abroad

As Bill Clinton scrambles to keep his Presidency afloat, he can take comfort in this: The record 7½-year-old economic expansion that has sustained his approval ratings—and helped convince Americans that it would be foolish to dismiss him over a sordid sex scandal—isn't likely to let him down. Indeed, unless Clinton is forced to resign or is impeached—provoking a severe crisis of confidence and policy paralysis—most economists expect the U.S. to continue to grow.

Still, as the recent gyrations in equity markets indicate, the economy's ability to grow will be seriously challenged. The emerging-markets meltdown is crimping U.S. corporate sales abroad. And deflating prices and rising wages are beginning to cut deeply into profits. In its Sept. 16 *Beige Book*, the Federal Reserve Board said "the economy is continuing to expand at a moderate

pace, although several districts indicated slowing in some sectors." The consensus view of economists surveyed by the *Blue Chip Economic Indicators* sees real gross domestic product rising at a moderate 2.3% annual rate in the last two quarters of 1998, little more than half the 3.6% gain in the first two. In 1999, growth is expected to drop to 2.2%. That would be the weakest pace since the 1990-91 recession.

And there are some who anticipate an even worse performance. William C. Dudley, chief U.S. economist for Goldman, Sachs & Co., has cut his 1999 forecast of GDP growth from 2.7% to a skimpy 1.7%. One reason: As the global economic crisis spreads from Asia and Russia to the Western Hemisphere, U.S. exports will suffer greatly. "The issue is not Clinton. The real issue is Brazil and Latin America," he says.

Already, collapsing exports are pun-

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BREAKING THE PLASTIC MOLD.

The Starr Report isn't likely to derail growth—unless it leads to a protracted battle over impeachment

ishing U.S. manufacturers. The trade deficit has mushroomed and subtracted 2.5 percentage points from real GDP growth so far this year. In its wake, factories have pink-slipped 154,000 workers since payrolls peaked in March. That's even with some 140,000 employees who returned to work in late July after the General Motors Corp. strike. A post-strike rebound in vehicle production boosted industrial output by 1.7% in August. But falling exports are restraining the gains in output of capital machinery, appliances, and electronics.

Another worry is the slowdown in capital spending. The growth in indus-

luxury vacations, and second homes.

Wall Street won't revisit its recent highs until investors see a brighter picture for profits. Aftertax earnings of nonfinancial corporations have fallen for three quarters in a row, a decline that is approaching the dip experienced during the last recession. Certainly, global factors have contributed to the drop, but the main cause, labor costs, is home-grown. Over the past year, unit labor costs rose 2.4%, while prices were up less than 1%. "Corporations are really caught," says David Wyss, chief economist of Standard & Poor's DRI. "Employment costs are going up due to

ty has pulled the yield on a 30-year Treasury down to 5.2%. The bond rally will lower Washington's interest payments, a plus for the budget outlook, while cheap mortgages will keep housing affordable.

Perhaps the most important factor keeping the expansion on track will be the remarkable performance of inflation. Producer prices fell 0.4% in August, and consumer inflation remains below 2%. Commodity prices are in a deflation spiral, while nonoil imports in August were 4% cheaper than they were a year earlier. Extremely low inflation gives the Fed leeway to cut U.S. rates as

Why Growth Is Slowing, But Not Stalling Out



trial capacity is already eclipsing even the economy's stellar 3.6% pace of the first half, and the percentage of idled plants is increasing in most industries.

The overhang could become more severe in the wake of the U.S. stock market correction, which has shaved 14% off the Dow Jones industrial average since July 17. With the plunge in stock prices, Americans are rethinking investment plans. Equity gains had financed a big part of the five-year-long capital-spending blitz, while the "wealth effect" made consumers more at ease with buying more and saving less. The stock market runup also fueled the housing boom.

LESS FROTH. Now, says Robert V. DiClemente of Salomon Smith Barney, consumers will scale back a bit. He was projecting an extra \$100 billion in spending financed by asset appreciation over the next two years. Now, he says that's down to \$20 billion and shrinking. DiClemente thinks consumers will forgo "froth spending"—items such as jewelry,

tight labor markets, but they can't pass it on due to the strong dollar and import competition." That won't change until labor markets loosen, which DRI doesn't expect to happen until late 1999.

Yet for all its increasing negatives, the economy overall still looks secure. Job growth has slowed from a monthly pace of 350,000 in late 1997, but thanks to the strong service sector, new hires still average around 200,000 a month. So far, that pace—along with real wage growth—has been large enough to stop households from relapsing into a case of the job jitters, even as layoffs rise. Moreover, while increasing labor costs wreak havoc on profit margins, they also provide consumers with fatter paychecks to keep shopping. With retail sales up 0.2% in August, real consumer spending is probably growing at a 2% annual rate in the third quarter. True, that's a third of the pace in the first half, but it's healthy enough to keep the economy moving.

In addition, the global flight to quali-

a way to rescue overseas economies

Against the fundamentals of solid job growth, low inflation, and low interest rates, the Starr Report would appear to be a small burr in the economy's backside. The danger is if the Republican Congress pursues the scandal all the way to impeachment. With the President under siege and a preoccupied Congress, the ensuing political vacuum could lead businesses and consumers to delay spending plans until they see how the dust settles on Capitol Hill.

Until now, Clinton's greatest success has been to preside over an unprecedented economic expansion. But if the scandal and a protracted impeachment investigation lead to a drop in demand—and a real economic downturn—it would appear that Clinton's own foibles would be the straw that broke that expansion's back.

By Kathleen Madigan in New York with Mike McNamee in Washington and William C. Symonds in Boston

FINANCIAL SERVICES: VALUE AMID THE CARNAGE?

But "buyer beware" remains the rule

Is it safe yet? That's the question many money managers are asking about financial-sector stocks. Banks and brokerages—including Lehman Brothers, J.P. Morgan, Citicorp and public New York—have been among the most heavily wounded in the market carnage this summer. But, contends James Ellman, manager of AIM Global Financial Services Fund: "A lot of bases have been thrown out with the bathwater." In other words, it could be time for some financial stocks to stage a comeback.

But there's good reason for the market's skittishness. Each week brings fresh news of more billions lost by bankers and traders in Russia, Asia, and other emerging markets. Then there's the prospect of slower growth at home. Many fund managers remain wary of money-center banks. But they note that many regional banks, brokerage firms, and mutual-fund companies offer good values at today's prices.

SEE FALL. How bad has the sell-off been? The Standard & Poor's Financials Index is down 23% from its 52-week high. While the Standard & Poor's 500-stock index trades at 24.6 times estimated 1998 earnings, the financials index is just 16.5.

The discount may be deserved: Analysts are working overtime to cut earnings projections for banks and brokers. At the beginning of July, analysts expected 9% earnings growth in 1998 for 100 brokerage companies—but now they expect no increase for the year. Several weeks ago, analysts were predicting flat earnings for brokers for the third quarter, but they now expect

earnings to fall 32%, according to First Call Corp. For money-center banks, analysts are looking for a 26% profit drop for the third quarter.

Some of the most brutal market blows have been felt by the big banks. David S. Berry, director of research at Keefe, Bruyette & Woods Inc., says bank stocks are being pummeled the way they were in the 1980s, when they had less capital and lower profits. But, Berry argues, the industry is in "rather better condition" this time.

That may be, but it doesn't diminish the risks that the banks still face from the emerging-markets meltdown.

"What you need to see is a clear solution to the offshore problems," says Thomas Goggins, manager of the John Hancock Financial Industries Fund.

Analysts are more bullish on regional banks, which aren't as exposed to overseas turmoil. Even Charles Peabody, the Mitchell Securities analyst who has been warning for more than a year that bank stocks could face big problems, is recommending PNC



Many regional banks, less vulnerable to global fallout, are good bets. So are some mutual fund firms

Bancorp and Fleet Financial Group. Berry prefers First Union Corp. Michael J. Stead, portfolio manager for SIFE Trust, is a fan of Hibernia Corp., a Louisiana bank hurt because of some exposure to Latin America. He has faith in the bank's CEO, Stephen A. Hansel, who "has a very keen eye for maintaining loan losses to a minimum and has done a great job of redoing the bank."

RUMORS. Investors have been far more worried about brokerage stocks. "Conditions were so uncertain at one point for the global houses that even the faintest hint of bad news tended to be overplayed," says Financial Service Analytics analyst Michael A. Flanagan. Lehman Brothers, for instance, was rumored to be filing for bankruptcy protection—a rumor the firm denies and analysts believe is unfounded. Merrill Lynch & Co. has taken some trading losses, and more hits are possible. But to justify the beating the stocks have taken, "you have to assume that this is permanent, that the big bull market of the 1980s and 1990s is over," says

THE FIASCO IN FINANCIAL STOCKS



WHO'S FEELING THE PAIN

SECTOR*	7/17/98 - 9/15/98
INVESTMENT BANKS/BROKERS	-39.0%
MONEY-CENTER BANKS	-32.0
MAJOR REGIONAL BANKS	-16.5
MULTILINE INSURERS	-26.0
STANDARD & POOR'S 500	-12.6

*All groups are Standard & Poor's industry groups
DATA: BLOOMBERG FINANCIAL MARKETS

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Raphael Soifer, bank analyst at Brown Brothers Harriman & Co. "If the market is going to turn around and we are going to have a generally good market in 1999, these stocks are cheap."

Of course, that's a big if. And even now, brokerage stocks trade at relatively lofty price-to-book-value ratios, says Dean Eberling of Putnam, Lovell, de Guardioli & Thornton. One exception is Lehman Brothers, which trades at a price-to-book ratio of 1.5—a level not seen since 1990. Eberling says the hit to Lehman's stock is overdone and that the company has done "a fabulous job of recasting itself over the last three years." As for Morgan Stanley, he cites its "great franchises" and "strengthened position in the global game." Ronald Elijah, manager of the Robertson Stephens Value + Growth Fund, bought Charles Schwab recently, still likes longtime holding Merrill Lynch, and is looking at other brokers "because they're down so much."

THE BOOMER CARD? Mutual-fund companies aren't escaping the blood-bath, either. As portfolio values drop, so do earnings. But some fund managers vow their firms are now unfairly undervalued: Affiliated Managers Group Inc. announced on Sept. 11 that it would buy back up to 5% of its shares. AIM's Ellman likes Alliance Capital Management and Franklin Resources for their large fixed-income and money-market operations. "We know the boomers will keep retiring," he says. "They'll have to put their savings somewhere. If it's not in the stock market, it will most likely be in the fixed-income market." At 29%, Franklin is down 48% from its 52-week high and down 29% for the year. Alliance, while down 23% from its 52-week high, is up 17% for the year.

American Express Co. has also suffered. Its stock is down 28.4% from its 52-week high. Babson Value fund manager Nick Whitridge, a longtime holder of the stock, thinks that with long-term earnings growth potential of 14% a year, and a price-earnings multiple of about 14.5 times estimated earnings for 1999, the stock is "a reasonable value, not really dirt cheap."

Sure, if the international crisis abates and the market continues to rebound, these financial stocks may turn out to be screaming buys. But for now, investors might want to wait until the picture becomes clearer before betting the ranch on the newly volatile sector.

By Suzanne Woolley, with Gary Sil-



OMIDYAR: Facing a tech-averse crowd

HIGH TECH

CAN IPOs ACHIEVE LIFTOFF AGAIN?

eBay is betting the Street is ready to back tech startups

Just weeks ago, investors couldn't get enough of high-tech IPOs. High-fliers such as GeoCities—even though they had no earnings—sold initial public offerings of their shares and watched as their new issues jumped 50% or more in a day.

But IPOs that would have headed for the stratosphere in June now are having a hard time getting off the launchpad. Consider eBay Inc., a hot Internet upstart scheduled to go public around Sept. 23. Chairman and co-founder Pierre Omidyar, who won't comment about the offering, is out hawking his company's stock to investors who generally want little to do with tech IPOs—at least until Wall Street's roller-coaster ride smoothes out.

"Investors are focused on damage control with their existing names rather than looking for new names to buy," says D. Rex Golding, co-head of global technology banking at Morgan Stanley Dean Witter. Who can blame them? Shares of the 126 technology companies that went public this year are down an average of 12.8%, ac-

cording to researchers CommScan LLC, while the Standard & Poor's 500-stock index is up 6.2%.

One result: Since July, 103 planned initial public offerings—more than a quarter of them in high tech—have been postponed or scrubbed, CommScan says. "If the market stays down or continues to decline that will ultimately create a very big fi-

nancing problem for technology companies," says Roger McNamee, a partner at Integral Capital Partners.

Omidyar's eBay, though, is one company that most analysts believe can still make a splash. The San Jose (Calif.) based online auction service is already profitable—it earned \$348,000 on nearly \$15 million in sales in the first six months of 1998. The company takes a cut from the transactions between individuals who go to its Web site to trade everything from stamps to dolls.

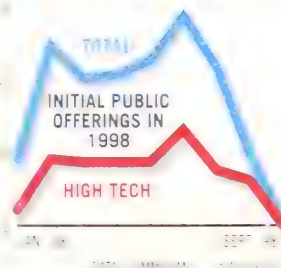
The eBay offering is widely seen as a test of whether investors want to dive back into the most promising high-tech IPOs. It will also indicate whether the lofty valuations given to one-time tech darlings such as Yahoo! Inc. and Amazon.com Inc. are a thing of the past.

"GROUNDHOG TEST." Should the eBay IPO fly, investors will turn their attention to another hot Internet play, Healtheon Corp. The company, which uses the Net to connect insurers with health-care providers and is backed by Netscape Communications Corp. founder James H. Clark, is to go public in October.

Healtheon is taking nothing for granted. Company executives are holding weekly phone conferences with bankers to gauge the mood on Wall Street. "It's the groundhog test," says director C. Richard Kramlich. "The underwriters put their heads up to see if it's going to be a sunny day or not." Healtheon and eBay can only hope the weather changes soon.

By Linda Himelstein in San Mateo, Calif.

A SMALLER APPETITE FOR IPOs



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MOTOROLA PUTS A CHIP PLANT ON HOLD

STILL STRIVING TO RECOVER from problems in its telecom businesses, Motorola is sounding a retreat—at least temporarily—in semiconductors. Citing slumping chip demand, Motorola announced on Sept. 16 that it is postponing construction of a huge chip plant in West Creek, Va. That was to be Motorola's largest investment worldwide, costing \$3 billion and expected to employ at least 2,500 workers making a range of products. But with chip sales forecast to fall 2% this year and Motorola anticipating its second straight dismal quarter, "we had to take a hard look at capital spending," says a spokesman. Motorola says it

will resume construction once the industry rebounds.

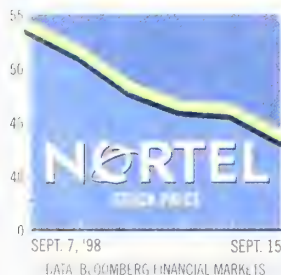
HINTS FROM A JUDGE ABOUT MICROSOFT

U.S. DISTRICT COURT JUDGE Thomas Penfield Jackson's Sept. 14 decision to delay the Justice Dept.'s suit against Microsoft until Oct. 15 came as no surprise: Both sides had asked for more time to prepare. But Jackson's denial of Microsoft's motion to dismiss the suit held hints about how he might approach the case. A June appellate court ruling had been expected to thwart Justice's case on Microsoft's right to bundle products. But Jackson wrote that Justice could address the tying issue if it shows that PC makers can create systems as efficient as Microsoft's when they combine a rival browser with the Windows system.

CLOSING BELL

CROSSED SIGNALS

Northern Telecom investors, already antsy about the \$8.4 billion purchase of network-gear maker Bay Networks, took the news of coming layoffs badly. On Sept. 15, Nortel confirmed that it plans to slash 4% of its workforce worldwide and take a still unspecified third-quarter charge. The stock fell 2%, to 43%, on the news. Investors fear the cuts are a sign of dimmer growth prospects. But Nortel says it must "resize" to pursue growth in broadband, wireless, and other emerging technologies.



ABBOTT'S NEW CEO HAS A YEN FOR DEALS

ABBOTT LABORATORIES turned to the dark horse in its three-way race for CEO: 43-year-old Miles White. And in looking to White, head of Abbott's \$2.7 billion diagnostics unit, the board may be signaling plans to ramp up dealmaking. White, who will succeed Duane Burnham on Jan. 1, has used acquisitions of companies such as MediSense, a maker of testing kits for diabetes, to expand Abbott's equipment business amid intense price pressures. White says he's committed to expanding Abbott's business lines, but is "skeptical of the value of megadeals" in health care.

CIENTA COULD USE A SAVIOR

THESE ARE TOUGH TIMES AT Ciena. The telecom-equipment maker's \$4 billion merg-

HEADLINER: GERALDINE LAYBOURNE

OXYGEN GETS AIRBORNE

WHEN GERALDINE LAYBOURNE resigned as cable chief for Walt Disney in May, Disney amiably became a minority investor in Laybourne's multimedia venture, Oxygen Media. Now, Laybourne has landed another key partner for Oxygen, which plans to develop TV programs and other content for women and kids. On Sept. 15, America Online took an undisclosed minority stake. As part of the deal, Oxygen will get three women's sites now offered on AOL's "Women's Channel."

The three sites—Electra, Thrive, and Moms Online—

will be the basis of an online women's cybercommunity Laybourne is planning.

And she intends to use that community as a test market for her ideas for TV programming. She calls this "the vacuum cleaner method of getting information" on what will fly on TV because opinions and feedback flow so freely. "The media has underestimated women, the same way they underestimated kids," says Laybourne—who ought to know. In a former life, she was credited with building Nickelodeon into the top kids' cable channel.



By Richard Siklos

er with Tellabs fell apart on Sept. 14, and Ciena's stock is off 86% from its recent high closing price of 88%. Ciena plans to start selling to the Baby Bells next year, diversifying from long-distance carriers. And CEO Patrick Nettles is investigating what he calls "legally questionable activities" by AT&T and spin-off Lucent Technologies that may have torpedoed the Tellabs deal. Lucent denies any wrongdoing, and AT&T won't comment. But analysts think Ciena should look for another white knight—maybe its partner Cisco Systems.

THE U.S. RELAXES ENCRYPTION RULES

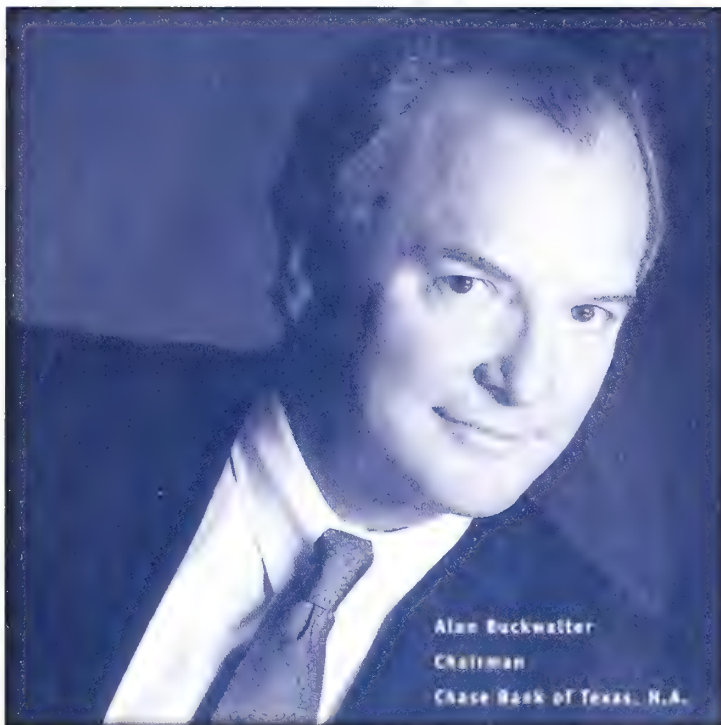
U.S. COMPANIES GOT A BOOST in their efforts to export encryption products on Sept. 16. Vice-President Al Gore announced a new Administration policy relaxing some controls on exports of encoding and de-

coding technology. It eliminates restrictions over sending encryption technology to overseas subsidiaries of U.S. companies or to insurance firms and online merchants in some 45 countries. It also raises the limit on the strength of encryption codes that can be easily exported. Some software execs say the measures fall short. The nation isn't "close to a final resolution of this issue," says Ed Gillespie, head of trade group Americans for Computer Privacy.

ET CETERA . . .

- Toys 'R' Us will take a \$495 million third-quarter restructuring charge.
- Venator Group is closing 570 stores and focusing on sneakers and sports apparel.
- Juniper Networks unveiled an Internet router 10 times faster than Cisco's best.
- BankAmerica announced \$330 million in pretax quarterly trading losses.

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GERMANY

SCHRODER'S MOMENT?

A Socialist may take the reins at a turning point for Germany

By the time the candidate arrives just after 5 on this dank evening in Frankfurt, a cold rain is falling. But the crowd gathered to rally for Gerhard Schröder, the Socialist who aims to oust Helmut Kohl as Germany's Chancellor, is unfazed. As Schröder pushes onto the stage, the applause is wild. Never mind that his speech is little more than slogans about "modernizing" the economy and ensuring "fairness" for working people. The crowd loves it. "The Socialists will take from the rich so that everyone can live," says Svenja Haeder, 18, a high-schooler who came with her parents. "That's fair. Everyone should be safe."

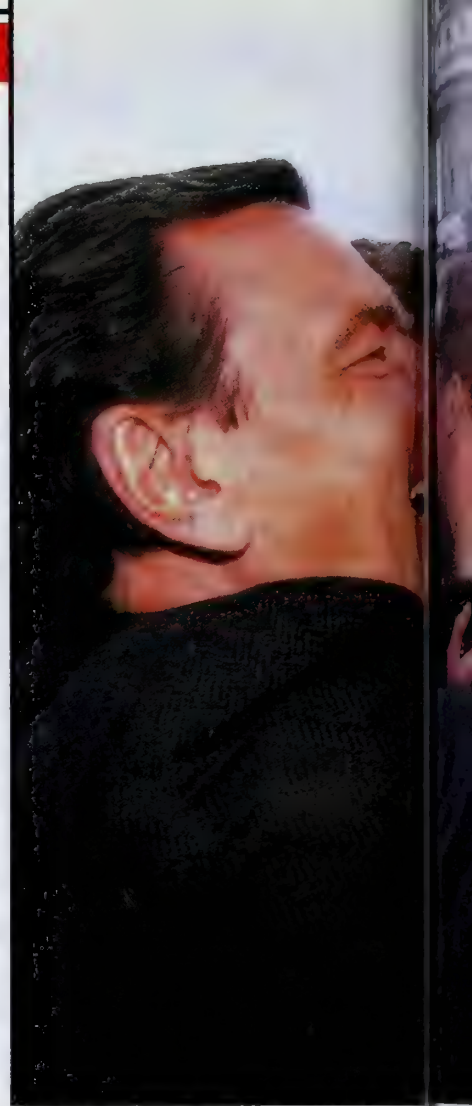
Meet Continental Europe's rising political star. His "New Middle" program aimed at bridging the gap between business and labor is vague, and his Social Democratic Party (SPD) may win by only a narrow margin when Germans head to the polls for parliamentary elections on Sept. 27. But this onetime radical lawyer from the state of Lower Saxony has touched a nerve with his com-

patriots, who after 16 years are tired of government by Kohl and his Christian Democrats—and worried about their economic future. Although Kohl has a chance to pull off a last-minute victory in the German vote, polls show that Schröder could win by at least a three-point margin. Some say the election is too close to call.

The election is a watershed event for Germany—and for Europe. If Schröder wins, the media-savvy 54-year-old will be the first representative of Germany's postwar generation to govern the country. His style of leadership would contrast with that of the 68-year-old Kohl, who has earned a place in history by shepherding grand projects such as German reunification, aimed at undoing the damage of the cold war. Most important, Schröder would take the reins at a turning point, just as Germany jettisons its beloved mark and Europe launches its single currency, the euro.

WEAK OR STRONG? How Schröder leads Germany would have a decisive impact on Europe's economic and political direction into the next century. He would not only head the largest economy but would play a key role in defining Europe's relationships with the U.S. and Asia. His policies would help determine whether Europe as a whole is competitive, whether its currency will be weak or strong, and whether its trade policies will be open or protectionist.

At the same time, though, Schröder faces unpredictable economic forces out-



side his control. The financial crises in Asia and Russia are threatening to slow Germany's growth and wipe out chance of cutting the 10.9% jobless rate. Deutsche Bank economists figure there's a 40% chance that the global crisis will cut Germany's economic growth from close to 3% next year to around 2%.

As Chancellor, Schröder would face stark choice: He could cast himself as new-style Social Democratic Chancellor and use his communication skills to convince Germans that their government must whittle away at benefits they've enjoyed since the 1960s. That would mean spurring growth with sharp cuts in social benefits and flexible hiring and firing rules. In essence

WHAT TO EXPECT IF SCHRODER WINS

DATA: BUSINESS WEEK

ECONOMIC REFORM

Although Germany's growth lags Europe's and joblessness is high, Schröder plans no overall cut in punishing taxes. Business fears he won't loosen labor laws or enact crucial pension reforms.

UNEMPLOYMENT

Schröder proposes bringing government, labor, and business together to create a jobs program. Executives worry that the plan will lead to government interference in corporate hiring.

PRIVATIZATION

Schröder is unlikely to push for privatization in banking and other state-dominated industries or for reduction in Germany's \$18 billion annual subsidies for sick industries.



RIGHT CHORD

Schröder's proposed wealth tax is popular with everyday folk, but business hates it

ibility for more hiring by companies. Such an approach has cut joblessness in the Netherlands to under 5%, he points out. But many executives doubt Germany's unions will accept small wage hikes and part-time work, as the Dutch unions did. Business leaders also fiercely oppose Schröder's proposal to reinstate a wealth tax that would cover unrealized gains on shareholdings.

LIMITS. Many executives believe Germany must cut taxes, slash government spending, and revamp labor rules far more than Schröder is likely to do. Their hope is that sweeping market forces, from deregulation to the euro, will compel even a Socialist government to implement some reforms. Once the euro is introduced, the gov-

ernment will come under pressure to either boost productivity or cut spending to keep Germany's budget deficit within the monetary union's limit of 3% of gross national product. "The euro will lead to more deregulation, more open markets, and less bureaucracy," predicts Commerzbank CEO Martin Kohlhaussen.

Schröder would try to pull left-wingers to the center, just as Britain's Labour Minister Tony Blair has done. Or Schröder can cater to the core of his party, which is controlled by old-line socialist Oskar Lafontaine. That would mean opting for populist measures such as wealth taxes.

Schröder's room to maneuver would be determined partly by the election's results. If the SPD gains a large bloc of seats, he is expected to form a government with the Green Party—giving the socialists a majority in the Bundestag, the lower House, which Kohl now controls, as well as in the Upper House. Another possibility is a grand coalition between the Social Democrats and the

Christian Democrats, only likely if the Socialists' margin of victory is narrow. Then, Schröder would have to constantly compromise with Wolfgang Schäuble, a tough, pro-business conservative. Kohl is expected to hand over leadership of the party to Schäuble if his party doesn't win enough votes to form the government.

For now, Schröder, who has been Lower Saxony's prime minister since 1990, is tilting to the left. He has pledged to roll back limited reforms that Kohl implemented, such as cutbacks in sick pay. He plans only modest cuts in the top corporate and personal tax rates, which range up to 45% and 53%, respectively. He says he will not cut Germany's tax base or slash social spending. Any income tax cuts will likely be offset by hikes in the gasoline tax.

To battle unemployment, Schröder wants government, labor, and business to devise a plan that would exchange wage moderation and labor flex-

ibility for more hiring by companies. Such an approach has cut joblessness in the Netherlands to under 5%, he points out. But many executives doubt Germany's unions will accept small wage hikes and part-time work, as the Dutch unions did. Business leaders also fiercely oppose Schröder's proposal to reinstate a wealth tax that would cover unrealized gains on shareholdings.

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In Germany, as in other leading industrialized countries, what's needed right now is a real leader. No matter how close the race, if Schröder wins, it will be because Germans believe he can finally provide jobs in a country that has been losing them for years. True to his slogans, the new Socialist Chancellor may feint left at first, but harsh realities are bound to soon limit his options. Like Lionel Jospin, France's Socialist Prime Minister, Schröder could well be forced to move toward the center even if many in his own party don't like it. How he chooses to get there could set the tone for German—and European—politics for years to come.

CURRENCY

Leaders fear the euro won't abide by deficit limits mandated under European union, especially a slump, thus slowing the euro.

FOREIGN AFFAIRS

With crisis gripping Asia and Russia, Europe may suffer a leadership vacuum until Schröder finds a way to emerge from the shadow of Kohl.

DATA: BUSINESS WEEK

INDONESIA

A TYCOON UNDER SIEGE

Can Anthony Salim salvage his family's assets?

There was a time when Salim Group, one of Southeast Asia's largest conglomerates, had everything. Its founder, Liem Sioe Liong, a Chinese immigrant to Indonesia, worked in his uncle's peanut oil shop in a backwater town, scraping together the savings to start a business. Along the way, he changed his name to the Indonesian-sounding Sudono Salim. More important, he befriended a hugely ambitious army officer named Suharto. After Suharto took over as President in 1966, he rewarded Liem with lucrative franchises in banking, flour milling, and telecom. By 1997, Salim Group had \$20 billion in assets and some 500 companies. Liem was not just big among the ranks of Southeast Asia's ethnic-Chinese tycoons. He was gargantuan.

A year later, Liem has fled Jakarta for the safety of Los Angeles, far from the rioters who burned down his Jakarta home in May during unrest that brought Suharto's resignation. With the old man out of the picture and Suharto in disgrace, Liem's son Anthony Salim is now scrambling to save his family's assets. But the mood in Indonesia has turned savagely against the tycoons who supported the old regime. "They should not expect the treatment they got in the past," says Ginandjar Kartasasmita, Coordinating Minister for Finance, Economy & Industry in the new government of President B.J. Habibie.

It is unclear how much of Salim Group Anthony will be able to salvage after his debts are paid. The government has seized control of the group's Bank Central Asia (BCA), the biggest



FIRE SALE

The riots that ousted Suharto in May put the heat on Anthony Salim's holdings, including BCA

private bank in Indonesia, charging it with improper lending practices. Regulators are demanding \$4.8 billion from Salim Group by Sept. 21 to cover the bank's debts. Otherwise, they threaten to begin seizing its assets. Habibie is also dismantling the monopolies on food staples that guaranteed the vast wealth and power of the Salims. And indigent Indonesian, or *pribumi*, business groups are lobbying Habibie to disman-

tle the group and parcel it out among them. The Indonesian depression has wiped at least 40% off the value of Salim's local assets, estimates Wilson Nababan, head of Indonesian credit agency CISA Raya Utama. "Even without the political pressure, Salim Group would still be bankrupt," says Nababan.

STRONGMEN. The Salim story has become a cautionary tale for the new Asia. Throughout the region, the shock of depression and political tumult is rocking the corporate empires that have dominated businesses and entire countries for decades. The tycoons who threw in their lot with the strongmen of pre-crisis days are finding the game changed. That's especially true for the Salims.

Yet Salim Group has big strength outside Indonesia, in corporations based



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in Hong Kong and Singapore, beyond the reach of Indonesia's new rulers. So it's possible Anthony can dig up funds through his outside empire to keep going. First Pacific Co., a Hong Kong-based property, banking, and telecom company, is a potential source of cash.

But with the bulk of its assets inside Indonesia, the group is exposed to the wrath of the government, which has mounted a public campaign to stamp out cronyism and corruption and make Indonesia a cleaner place to do business. "At some stage, they have become too dependent on government support," says Ginandjar. "Of course, now that has become a liability for them."

NO CHOICE. Salim did not respond to repeated requests for an interview for this article. But a Salim Group executive claims the company was forced into unprofitable businesses, such as flour milling, by the Suharto regime. "The government needed food," says the executive. "So it was an assignment. It wasn't that we wanted this." Company executives say they had no choice but to play by Suharto's rules if they wanted to do business in his Indonesia.

The Salims even today have Indonesian admirers who say the country needs able business leaders. Anthony, who returned from a London technical college in 1973, worked his way up from a low-level job. His father made him president and CEO in 1992. "Anthony Salim is the most intelligent and resourceful businessman in Indonesia," says CISI's Nabanan. Such confidence leads the CEO of a bank that funded the group to ask: "Will there be a sequel—*The Empire Strikes Back?*"

Meantime, Salim Group companies may soon test Indonesia's new bankruptcy law. Many analysts believe Salim Group has more than \$3 billion worth of foreign debt in three of its Jakarta-listed companies alone.

Then there's the local political mood,



THE SALIM EMPIRE

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INDOCEMENT

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BANK CENTRAL ASIA

Was Indonesia's largest private bank, now nationalized, has \$4.8 billion in debt.

BOGASARI FLOUR MILL

The world's largest flour mill. Now it has lost its subsidies.

FIRST PACIFIC

Hong Kong-based property, banking, and telecom conglomerate, 54% owned by Salim Group: \$750 million market cap.

METRO PACIFIC

First Pacific's troubled real estate affiliate in Manila

UNITED INDUSTRIAL CORP.

Singapore-based holding company for property, retail, and consumer goods. Sales of \$224 million.

DATA: BUSINESS WEEK, COMPANY REPORTS

which regards Liem as an old Suharto crony. A wave of anti-Chinese riots in May and attacks on property owned by the Suharto clan triggered a nationwide run on Salim's BCA, 30% owned by Suharto son Sigit Harjoyudanto and daughter Siti Hardiyanti Rukmana in an arrangement that Salim Group executives say they were forced to accept.

The run started on May 18 and lasted for weeks, wiping away the bank's capital. This suddenly gave the new government leverage over Salim Group. Anthony was the first Indonesian banker in trouble to ask the Indonesian Bank Restructuring Agency (IBRA) for help. IBRA responded by nationalizing the bank, recapitalizing BCA to the tune of \$3 billion. Then an audit found that the bank's corporate affiliates and shareholders, including the Suharto children, had been lending money to themselves in violation of Indonesian banking rules.

bankers close to the negotiations say the Salims probably don't have enough time to raise the cash. IBRA officials say the family will probably be left with no more than a 20% stake in their major holdings but that Anthony could still maintain management control.

If there is a real loser in this story, it could be Indonesia. Salim Group employs 200,000 Indonesians and has a hand in feeding all 211 million of them. BCA is the bank most used by Indonesian businesses. Salim's listed units—Indofood and Indocement Tunggul Perkasa—at one time made up 15% of market capitalization on the Jakarta exchange. "What do you get if you destroy BCA, Indocement, and Indofood? You destroy the economy," says one Jakarta economist. Yet whatever happens, the Salims must now pay for the exalted position they held for so long.

By Michael Shari in Jakarta

TOO CLOSE?

Cozy deals, like a government contract with this Indofood plant, underpinned the group's power

Bank Indonesia, the central bank, sets a limit to such intragroup loans at 20% of an entire portfolio; at BCA the ratio was 50%. IBRA wants an additional \$1.8 billion to make up for those loans.

The government has Anthony Salim in a corner. If he cannot repay the \$4.8 billion by Sept. 21, Jakarta can start seizing assets. The government has said it is prepared to seize noodle maker Indofood Sukses Makmur, Salim's profitable but debt-ridden company that makes 90% of Indonesia's noodles.

Yet Salim is negotiating with IBRA "in very good faith," says an economist familiar with the negotiations. It has already sold a small stake in Manila brewery San Miguel Corp. for \$70 million. And it could raise more cash by selling off parts of its holdings in Singapore.

REAL LOSER. But Jakarta



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Ted remembered from the in-flight article he had read.

In the Middle East, it's offensive to expose the soles of your feet. And here he was, the principal of an engineering firm, in Dubai, trying not to build the bridge too far.

¹(His company) was based in Reno, Nevada—which might seem like a strange place for an international engineering firm if the tax structure weren't so friendly. But that presented challenges. Most of Ted's colleagues were strewn to the four corners of the globe. The ability to ²(send e-mail and schedule meetings) was paramount—with architects in Salt Lake City, fabricators in São Paulo, financiers in Geneva. As their company grew, so did their reliance on the Web to ³(share information and get new clients). Control was critical. Because ⁴(managing projects on-time, on-budget) for his company and his clients was one of the reasons they were starting to win so many contracts. This, and their left foot not tripping over their right. Though today they wouldn't be propped up on a desk.

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EDITED BY JOHN TEMPLEMAN

IS MALAYSIA RIPE FOR A POPULAR REVOLT?

In an upscale Kuala Lumpur suburb, just around the corner from Domino's Pizza, a 40-year-old banker stands in front of Anwar Ibrahim's house, hawking *reformasi* bumper stickers. Vendors sell everything from Anwar buttons, 80¢ apiece, to Anwar T-shirts and videos, \$4. Business is brisk, as more than 10,000 Malaysians flock to the sacked Finance Minister's home most nights to hear him denounce Prime Minister Mahathir Mohamad's government.

The party won't last much longer. The police are threatening to charge Anwar with holding rallies without a permit. Even Anwar's most ardent fans expect his arrest after the Commonwealth Games end on Sept. 21. But Mahathir hasn't dared pounce as long as thousands of athletes, tourists, and dignitaries, including Queen Elizabeth II, are in town for the 10-day, \$5 billion sports jamboree.

SEEKING ALLIES. Like the track athletes, Anwar is in a race against the clock. From nothing, he's trying to build a political base capable of challenging Mahathir's United National Malaysian Organization, which controls all the levers of power. He aims to create what he calls "a movement of the people," a popular revolt to topple Mahathir.

It's a tall order, with a slim chance of success. Anwar's radical reforms would attack the heart of the system built by Mahathir and his UMNO party. He regularly denounces cronyism and wants to end bailouts of politically wired companies such as Renong. And he stresses political demands for more freedom, justice, and the rule of law.

His ideas appeal to disenchanted Malaysians as diverse as urban yuppies and conservative rural Muslims. "My intention is to ensure that this momentum can be sustained," says Anwar. He is counting on the recession to bolster his support. So far, however, Mahathir seems to have the upper hand as the stock market has stabilized and bank lending has

increased since Mahathir imposed currency controls on Sept. 1. But those gains may yet prove short-lived.

A second track, of forging ties with Islamic and Chinese groups in a grand anti-Mahathir alliance, is showing some success. Muslim leaders appear at Anwar's rallies, and Lim Kit Siang, head of the opposition Democratic Action Party, regularly visits his house. "There is definitely room to cooperate," says Lim. Anwar adds: "The reform agenda has transcended [partisan politics]."

Anwar has come a long way since he was fired on Sept. 2. For days, fearing imminent arrest, he kept to his house. But even as he speaks out, the deck is still heavily stacked against him. Mahathir controls the state-security apparatus and has begun piling on the pressure. However, he hasn't yet turned the big guns of the Internal Security Act on his former protégé as he has on other opponents in the past. A legacy of British colonial rule, the act allows the government to detain suspects indefinitely without trial. But its use could trigger widespread condemnation at home and abroad. "That would make Anwar a martyr," says one diplomat in Kuala Lumpur. "It's a real loser."

SMEAR CAMPAIGN. Instead, Mahathir's administration is attempting to smear Anwar with allegations of sexual misconduct, moral turpitude, and treason. A recently published book lays them out in graphic detail, though the government has not yet brought any formal charges. Anwar insists they are "fabrications." But, says the diplomat, "if people believe them, he's finished."

Anwar's downfall will also be complete if he can't build sufficient support to head off his own arrest. As long as he is free to speak out, he can get time—as well as a growing band of Malaysians—on his side and behind his ideas.

By Bruce Einhorn in Kuala Lumpur



ANWAR: Free for now

GLOBAL WRAPUP

GM RAISES SUZUKI STAKE

► General Motors Corp. will become the largest shareholder in Suzuki Motor Corp. Japan's No. 1 minicar maker said it will issue new shares to enable GM to raise its stake to 10% from 3.3% in a deal worth about \$296 million. GM already owns 37.5% of truckmaker Isuzu; competitor Ford owns 33.4% of Mazda.

Suzuki and GM hope eventually to develop jointly small, inexpensive vehicles for the developing world. The deal would not affect operations at Adam

Opel, GM's German subsidiary, which produces compact cars. Suzuki and Opel agreed in May to develop small passenger cars together for Europe.

EU PUSHES U.S. TRADE DEAL

► Brussels unveiled a slimmed-down plan to remove regulatory barriers from the European Union's \$320 billion annual trade with the U.S. The EU commission wants an early-warning system to avoid disputes over food safety and genetically modified crops.

The plan offers more mutual recog-

nition of product tests and technical specifications as part of the Trans-Atlantic Economic Partnership it agreed in May to negotiate with Washington.

An earlier version was shot down by France. The 15 European Union governments still have to approve the new plan before talks with the U.S. start. This time, though, EU trade czar Leon Brittan says that he does not expect major objections. The partnership, he says, will bolster "a pole of stability in a turbulent world economy."



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REHEATING STARBUCKS

Growth is tepid. Will restaurants, supermarket sales, and a push overseas brighten the bottom line?

It was a busy week for Starbucks Chief Executive Officer Howard Schultz. First, the company unveiled a new, lighter blend of coffee. Then, he heralded the Seattle opening of Cafe Starbucks, the coffee company's first full-fledged restaurant. Two days later, Schultz flew to London for the Sept. 17 premiere of Starbucks in Europe.

Quite a pace for a guy who made a fortune advising people to take a coffee break. But the 45-year-old Schultz is on a mission: He's out to prove there is still some zing left in those beans, as Starbucks Coffee Co. evolves from a high-flying startup to a maturing company with more level growth. With the buzz over lattes waning, Starbucks is brewing new ventures in restaurants and supermarkets to perk up sales. It is also searching for the next big hit with drinks such as Tiazzis, an icy concoction of tea and juice.

The company that made espresso a daily habit finds itself at a crossroads. Schultz argues that its new investments in brand extension are necessary if Starbucks is to maintain an impressive growth pace in the coming years. "We have to keep pushing the envelope and reinventing ourselves," he says. But in the near term, the moves are raising questions about how far the chain can stray from its coffeehouse roots without losing its way.

Investors have come to expect a lot from Schultz and his team—and they weren't shy about expressing their disappointment when management stumbled this summer. Starbucks' stock

price has plunged about 50% since early July, as the company announced lackluster 2% growth in same-store sales for July and nudged analysts' predictions toward the lower end of 1999 earnings estimates. The company has told analysts to expect earnings to grow 30% to 35% for the next several years. That's not bad—unless you've been delivering 42% earnings growth, as Starbucks has on average for the past four years. Wall Street expects earnings of \$82 million on revenues of \$1.3 billion for fiscal 1998, which ends on Sept. 27, according to Zacks Research.

The slowdown in comparable-store sales gives investors the jitters because Starbucks' retail stores provide 85% of the company's revenues. From its start in 1971 as a small whole-bean store in Seattle, Starbucks has grown to 1,800 outlets and continues to open a store a day. The company admits that it cannibalizes 30% of its own store sales by opening shops near each other, with the trade-off being that it saves money on marketing and distribution costs through clustering.

To stay ahead of mounting competition, ranging from Dunkin' Donuts to smaller chains such as Tully's Coffee in Seattle and Coffee Station in New York City, Star-



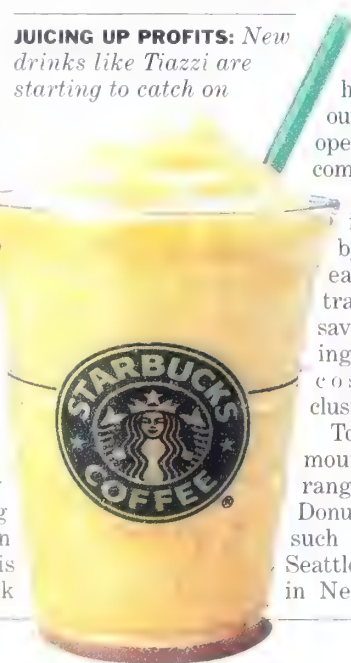
FOOD ON THE SIDE: Starbucks aims at the dinner trade

bucks has relied on a string of new hit products. Last year, the star was Frappuccino, a cold-blended drink that helped boost July, 1997, same-store sales by 7%. The chain hoped to follow up this summer with Tiazzis, a blend of tea and juice. But Starbucks kept tinkering with the recipe and didn't get the mixture to stores until July 12. Tiazzis appears to be catching on—August store sales grew 3%, two-thirds of it from Tiazzis. But sales growth is clearly slowing down.

BEAN COUNTING. That's why Starbucks is reaching out to grocery stores and restaurants. Its initial forays onto supermarket shelves—with bottled Frappuccino, a joint venture with PepsiCo Inc., and coffee ice cream, in a deal with Dreyers Grand Ice Cream Inc.—have been hits. And Schultz is relying on the strong Starbucks brand image to give it a leg up in the coffee aisle, where 60% of all java is sold.

Shoppers don't get a price break on a 12-ounce package of Starbucks beans—the supermarket price is comparable to what you pay at a corner Starbucks store. But even with that premium over volume-brands like Maxwell House and Folgers, analysts question whether Star-

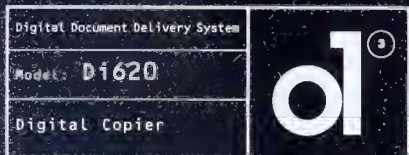
JUICING UP PROFITS: New drinks like Tiazzis are starting to catch on



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bucks can maintain its traditional 6% profit margins after paying supermarkets for shelf space and brokers for distribution. Starbucks executives insist they can compensate by shifting other costs, such as shipping and marketing, to the grocery stores and brokers. And they're not worried about the supermarkets siphoning away coffee-store business. A trial last winter in Chicago proved most people went to Starbucks for a quick jolt and didn't like hauling a bag of beans back to work.

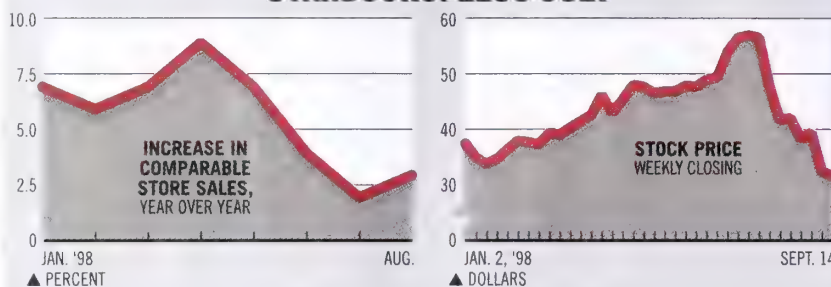
The return on Starbucks' restaurant venture is less certain. Starbucks opened its first Cafe Starbucks to capacity crowds on Sept. 11. Another three restaurants are planned in Seattle by the end of the year. The concept is an attempt to stretch Starbucks' business further into the evening. Right now, 85% of business is completed by 3 p.m. If the restaurants are successful, look for a

nationwide rollout. However, offering hot meals, full service, and a bar with coffee liqueur drinks is more complex and costly than pulling a shot of espresso. "It makes me nervous," says Harvey G. Bateman, principal portfolio manager for Sirach Capital Management Inc.,

despite Japan's recession. In fact, the depressed Asian economy is offering Starbucks great real estate deals. In Europe, meanwhile, Starbucks snatched up London-based Seattle Coffee Co. for 1.8 million newly issued shares worth \$84.5 million. The acquisition diluted earnings by

5% in fiscal 1998 but the 61-store British chain gives Starbucks a base from which to expand to the Continent. The overseas expansion will certainly be pricey. Still, Mitchell J. Speiser, analyst at Lehman Brothers, thinks foreign operations could contribute 25% of Starbucks' total

STARBUCKS: LESS JOLT



DATA: STARBUCKS COFFEE CO., BLOOMBERG FINANCIAL MARKETS

which trimmed its Starbucks holdings from 1 million to 700,000 shares in August. "It defies the simplicity of the Starbucks model."

Meanwhile, Schultz plans to go even farther afield. He talks of opening 500 stores in Europe and Asia over the next five years. Already, lines go out the door at the 23 existing Starbucks in Tokyo,

earnings within five years.

Of course, there's no saying how premium-coffee sales will hold up if the world economy falls off a cliff. But then, who would have guessed 10 years ago that people would be lining up to pay \$2 for a cup of joe?

By Seanna Browder in Seattle with Emily Thornton in Tokyo



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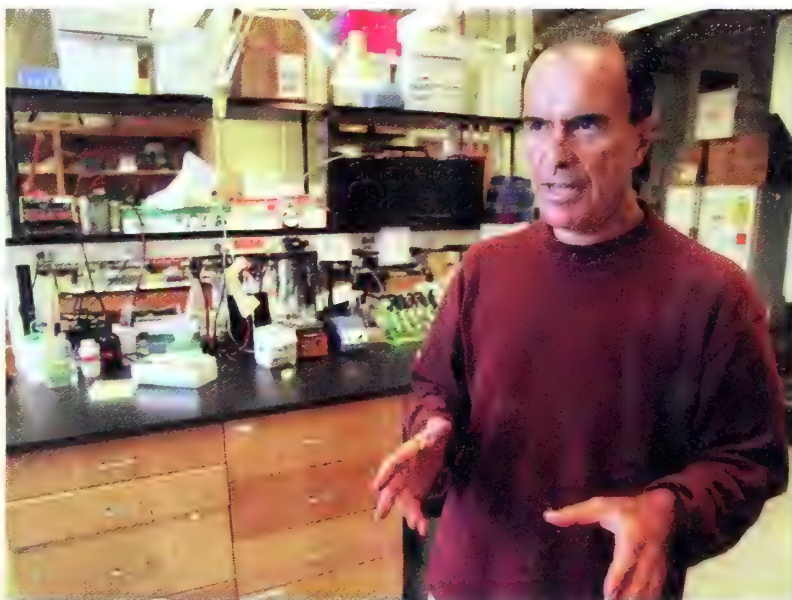
THE NEW FRACAS OVER FAT PILLS

How safe is the combination of Prozac and phentermine?

In late August, one of the nation's most respected drug researchers, Dr. Richard J. Wurtman, dropped a bombshell on the diet-drug industry. He presented new evidence that could explain why the once wildly popular obesity drug combination known as fen-phen seemed to cause serious heart problems. Because of these problems, fenfluramine, one of the drugs in the combo, was voluntarily pulled off the market a year ago. Phentermine, the other half of the pair, is still available and is now commonly used in combination with the antidepressant Prozac to treat obesity. But Wurtman warned that the Pro-phen combination could be just as dangerous as fen-phen.

That warning alarmed obesity experts because, unlike previous studies, it implicated phentermine. Wurtman suggests that phentermine's label should have been changed long ago to say that the drug alters the blood's chemistry by inhibiting the action of an enzyme known as MAO. The labels of fenfluramine and Prozac both carry express warnings that they should not be taken with drugs that act as MAO inhibitors.

Wurtman's claims have been furiously attacked by some diet-drug companies, already under siege from lawsuits related



WURTMAN: Setting off alarms in the pharmaceutical industry

to the fen-phen combination. His research is "blatant, unsupported advocacy," said Medeva Americas Inc. It's "incorrect and totally misleading," complained SmithKline Beecham PLC. "There is no evidence that phentermine is an MAO inhibitor of clinical significance in humans." Wurtman, director of Massachusetts Institute of Technology's renowned Clinical Research Center, and co-author Timothy J. Maher, a professor at Massachusetts College of Pharmacy, were accused of conflicts of interest and of supporting "junk science."

The conflict-of-interest charges arise because Wurtman is a co-developer of a competing diet drug—Redux, a form of fenfluramine. He is also co-founder of Cambridge (Mass.)-based Interneuron Pharmaceutical Inc., which made Redux. Wurtman dismisses the criticism, pointing out that Interneuron pulled Redux from the market worldwide last year and has no interest in trying to reintroduce it. Interneuron on Sept. 6 also negotiated a settlement of all lawsuits alleging harm from Redux.

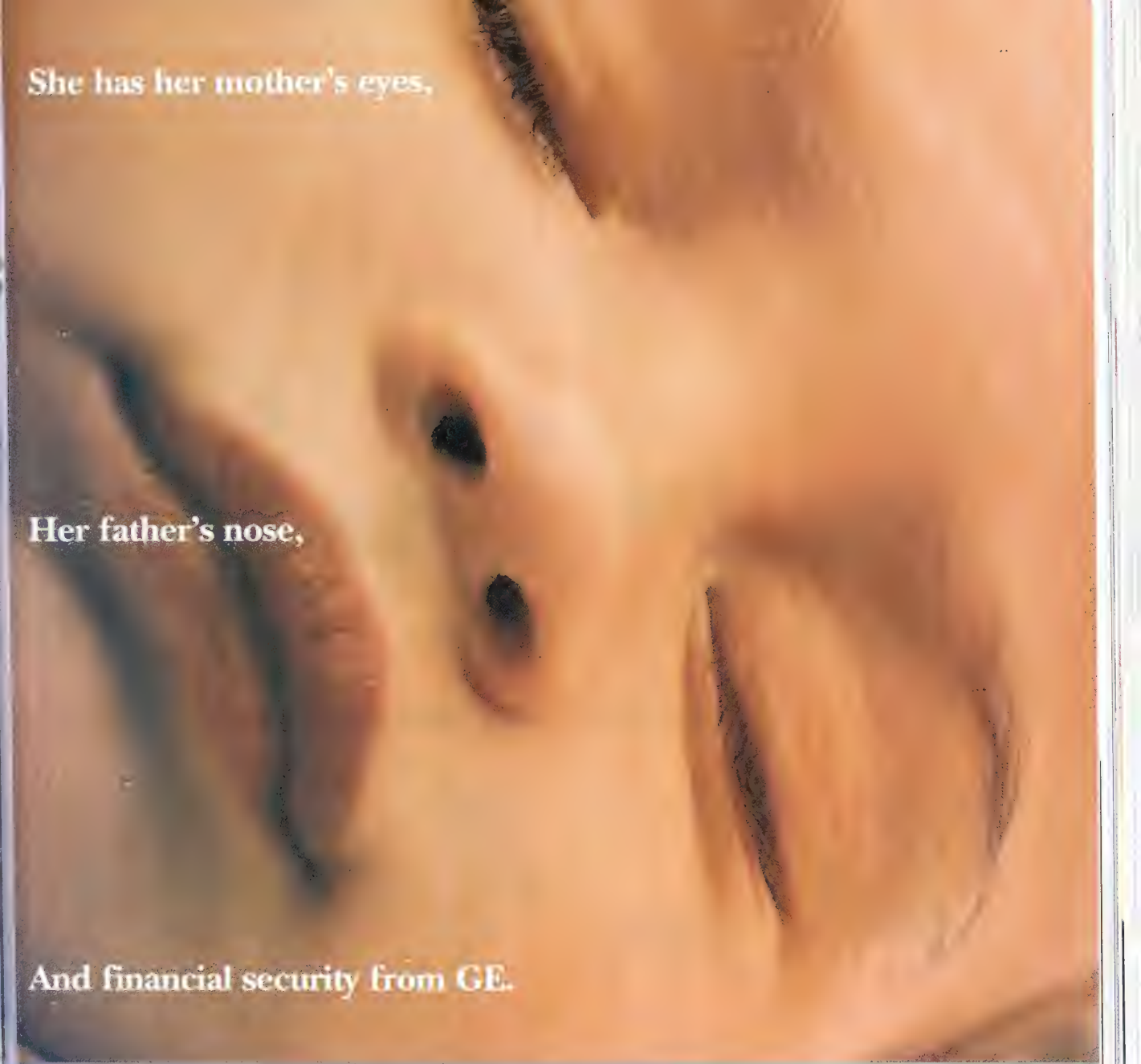
Wurtman says phentermine's makers were irresponsible in failing to uncover the problem themselves. "I would hope that Medeva conducted their own research," he says. "The fact is, this should have been stated on the label." Medeva responds that the earlier research on phentermine "demonstrated that phentermine's MAO inhibitory potential is very weak."

WHOSE JOB? The controversy over phentermine highlights a long-standing problem at the Food & Drug Administration (FDA). The agency's top priority is to clear the way for the marketing of new drugs. Few of its resources are aimed at monitoring and updating the labels of older drugs. That job is left largely to the drugmakers, which must file yearly reports with any new information on their drugs. Medeva and SmithKline both say the FDA was notified of the earlier research on phentermine.

Why didn't the FDA act? Dr. James Bilstad, director of one of the agency's drug-evaluation offices, would not comment on the possible dangers of the phentermine combination or whether the FDA considered changing the label. "There are hundreds of articles published on drugs all the time and not everything merits mentioning in the label," he said. Wurtman and Maher maintain their work confirms research on phentermine that was first published in the early 1970s. That information

BAD MIX? Findings suggest that phentermine's label should long ago have listed risks if taken with Prozac or fenfluramine





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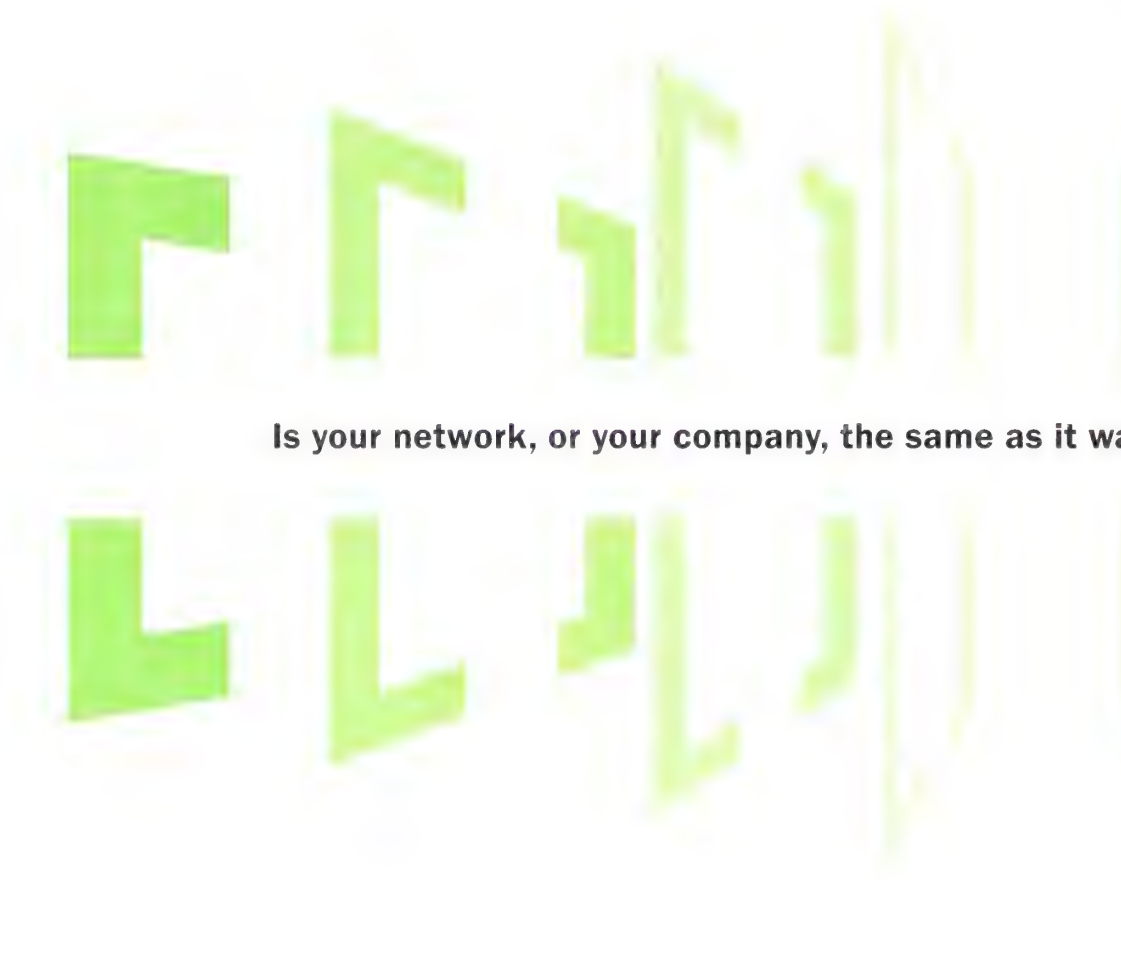


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they say, should have been added to the drug's label back then. Maher agrees with the manufacturers that the early literature characterizes phentermine as a weak MAO inhibitor. But "the labels of [fenfluramine and Prozac] say 'never give these drugs with an MAO inhibitor,'" he says. "They don't say 'never give with an MAO inhibitor unless it's weak.'"

This is a high-stakes battle. Phentermine, an amphetamine-like drug, has been a popular treatment ever since its approval as a short-term appetite suppressant in 1959. A generic version has been available since 1976. Sales soared in 1992 when doctors discovered that a combination of phentermine and fenfluramine worked better than phentermine alone. In 1996, sales of phentermine totaled \$124 million but fell to \$25 million

in the first half of 1998 after fenfluramine was pulled off the market.

Wurtman claims it's the combination that is the problem. Fenfluramine and Redux, as well as anti-depressants such as Prozac, raise levels of a brain chemical called serotonin that affects appetite and mood. Many scientists believe that if too much serotonin is released, it may damage heart valves and lead to a serious lung condition called primary pulmonary hypertension. The companies say the link between serotonin and heart damage has not been proven.

The body has two ways of mopping up excess serotonin—by absorbing it into blood platelets or soaking it up with the MAO enzyme. Phentermine inhibits the action of MAO; Prozac, fenfluramine, and Redux prevent the platelets from

soaking up serotonin. When phentermine is given in combination with one of the other drugs, the body has no way to soak up excess serotonin, Wurtman says.

DATABASE DISCOVERY. Maher first decided to investigate the fen-phen combination in the spring of 1997. "I am always concerned about combination drugs because combinations are not approved by the FDA," he says. He did a database search of previous studies and found several from the 1970s suggesting that phentermine is an MAO inhibitor. He alerted Wurtman, but the two did little to follow up, because fenfluramine had been taken off the market.

They took a second look this summer, after Maher learned that obesity clinics are now regularly prescribing the Pro-phen combination. Wurtman, mean-

The Ups and Downs of Fen-phen

1970 research is only now coming to light

1959

Phentermine is approved by the FDA as an appetite suppressant for the short-term treatment of obesity.

1970

Phentermine is first found to act as an MAO inhibitor, blocking an enzyme that regulates the brain chemical serotonin.

1973

Fenfluramine is approved as a short-term appetite suppressant. Its label warns against use with MAO inhibitors.

1992

Studies suggest the combination of fenfluramine and phentermine can cause significant weight loss.



hile, was curious as to why fenfluramine and Redux had caused heart problems in the U.S. but few cases had been reported in Europe, where the drugs were not normally taken with phentermine. He gave phentermine to 7 healthy MIT students and was surprised to discover that their serotonin levels almost doubled. "That's when I remembered something that Tim had told me almost a year ago—that phentermine is an MAO inhibitor," he said.

The two scientists assembled a team of researchers to conduct experiments on rats. They discovered that phentermine did indeed block MAO in the animals in much the same way researchers had reported in the 1970s. Maher and Wurtman put together a presentation for the International Congress of Obesity in Paris in early September and announced their findings to the press.

The drug's manufacturers saw red.

Medeva issued a five-page statement arguing that Wurtman and Maher merely presented "a hypothesis in search of facts." Dr. Arthur E. Weyman, an adviser to American Home Products Corp. and professor of medicine at Harvard Medical School, also questions the researchers' conclusions, saying: "Nobody even knows that it is serotonin that is involved in the heart-valve problems."

"WE NEED GUIDANCE." Wurtman and Maher insist that they made no final conclusions. Their report says that phentermine "probably increases serotonin" when given with fenfluramine or Prozac. "I think we need guidance on this from the FDA," says Maher.

The two scientists have moved on to other research, and Wurtman says he hopes other studies will more closely examine the implications of taking phentermine in combination with Prozac. But the FDA is famously short of resources to

keep track of new information on drugs already approved. "These drugs are tested on only a couple hundred people, and the rare complications only occur when they are used on hundreds of thousands of people," says Dr. Alan L. Hillman, director of the Center for Health Policy at the University of Pennsylvania. "Unless some horrible thing happens, the drugs stay labeled that way."

Wurtman's work doesn't explain all the diet-pill problems. Studies just published in the *New England Journal of Medicine* found that Redux and fenfluramine can be linked to heart valve damage even when taken alone. Meanwhile, obesity clinics continue to prescribe Prophen, figuring the benefits outweigh the risks. That may be so, but the patient might still like to see those risks pointed out on the label.

By Catherine Arnst in New York and Amy Barrett in Philadelphia

1996

approved for term appetite ssion. The label hat the drug not be used AO inhibitors.

JULY, 1997

Some patients develop heart-valve problems while taking fen-phen. Fenfluramine and Redux are withdrawn, but not phentermine.

SUMMER, 1998

Timothy Maher, a pharmacologist, and Richard Wurtman, co-developer of Redux, show that phentermine is an MAO inhibitor.

AUGUST, 1998

Maher, Wurtman, and colleagues report the findings at an obesity conference, provoking criticism from phentermine's makers.

SEPTEMBER, 1998

The *New England Journal of Medicine* publishes three reports about heart-valve irregularities found in patients taking fen-phen and Redux.

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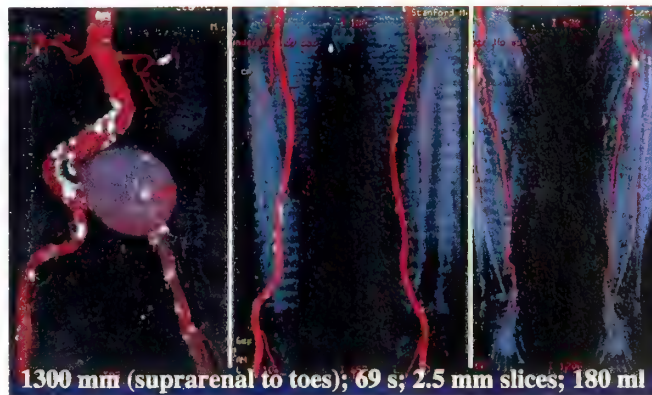
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DITED BY NEIL GROSS

FORD SLIPS NEURAL NET UNDER THE HOOD

FORD MOTOR CO. HAS A BETTER idea for diagnosing engine trouble: an advanced neural network program running on chips designed by NASA's Jet Propulsion Laboratory. Starting in 2001, the chips will continuously monitor Ford car engines for misfires caused by such problems as damaged piston rings.

Today, onboard computers can't detect misfires under all operating conditions. So they're built to be hypersensitive: they catch misfires, but with an unacceptable level of false alarms. Ford's neural net program does a better job because, like the human mind, it learns by doing. When fed data on deliberately induced engine misfires simulating all operating conditions, the program learns to spot problems with precision. JPL designed the hardware, compressing the electronic elements onto a chip. Ford has the right to license the chip to other carmakers, and JPL holds the rights for nonautomobiles. *Larry Armstrong*



QUICK WORK FROM A NEW CT SCANNER

GENERAL ELECTRIC CO.'S NEW COMPUTED TOMOGRAPHY (CT) scanner is a speed demon. Like earlier systems, it uses detectors to collect data from an X-ray source that circles a patient lying in the doughnut-shaped device. A computer translates the data into 3-D images, or slices of the patient's body. But instead of one row of detectors, GE's LightSpeed system uses 16. Doctors can see multiple slices simultaneously and scan the body six times faster than with existing systems.

That means doctors can begin to replace uncomfortable, invasive diagnostic procedures. At Stanford University, radiology department chairman Gary M. Glazer and his colleagues recently used the LightSpeed to examine a dilation, or aneurysm, in a patient's pelvic artery (picture, left). Ordinarily, the exam would require threading a catheter through the groin to inject special dyes. LightSpeed let the Stanford team skip the catheter. And they could simultaneously view the arteries of the patient's thigh and lower leg (pictures, right) to make sure that the vascular disease was localized. "We could study the leg vessels down to the toes," Glazer says, "and diagnose the patient in about a minute." □

A SEARCH ENGINE GETS A SEARCH ENGINE

WITH MOST INTERNET search engines, winnowing out the chaff can be tedious. For a broad search term such as "trek," the HotBot program (www.hotbot.com) from Wired Digital Inc. turns up some 169,000 matches—everything from Star Trek to mountain bikes. Only the most persevering surfers ever reach the treasures buried beyond the first few screens of links. But you can now piggyback on their diligence.

Direct Hit is a HotBot aid that prunes the number

of links to just the 10 top sites, including many far down the list. Direct Hit keeps tabs on which links are followed—but with a clever twist. Clicked-on links further down the list get progressively higher scores. So even if only a tiny percentage of people follows link No. 174, say, it could move into the Top 10, says Gary Culliss, chairman and co-founder of Direct Hit Technologies Inc. in Wellesley Hills, Mass. If Direct Hit has compiled the data for a ranking, then HotBot

will notify you at the top of its results page.

There's another ranking system that may be even better for managers. Google (<http://google.stanford.edu/>) rates Web sites by the number of other sites linked to them. The rankings, in other words, are determined not by surfers, but by Webmasters who presumably took time to evaluate a site before setting up a link to it. It's an adaptation of the time-honored practice of assessing scientific papers by the number of citations they've gotten in other papers. *Otis Port*

INNOVATIONS

■ Vegetables you might never find together in a salad are swapping genes to create useful new food products. Researchers at the Center for Plant Breeding and Reproductive Research in Wageningen, the Netherlands, last week reported that they had created a low-calorie, natural sweetener by adding a gene from a Jerusalem artichoke to sugar beets. The gene enables the beets to manufacture the sugar fructan—instead of sucrose, which is refined into table sugar. Fructan tastes plenty sweet, but it's much harder for the body to break down, so it doesn't add to the calorie count.

■ Unlike marching ants, they don't devour hapless creatures in their path. But army worms are on the march in Florida, Georgia, and other Southeastern states, where they are decimating thousands of acres of farmland. Up to 1.5 inches in length, the worms lay as many as 800 eggs at a time and can chew through a cotton field in 48 hours. Pest experts at the University of Florida say the most effective weapon is a new pesticide called spinosad, which kills the worms but leaves most beneficial insects unharmed. So far, spinosad has been approved for use on cotton fields.



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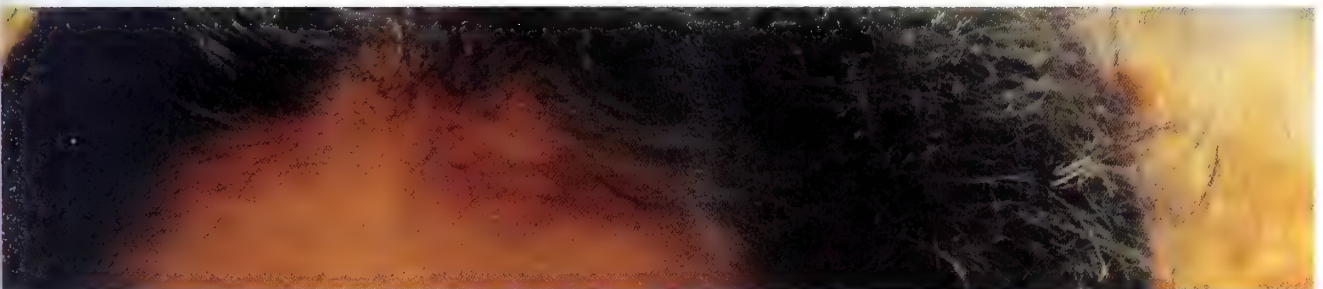
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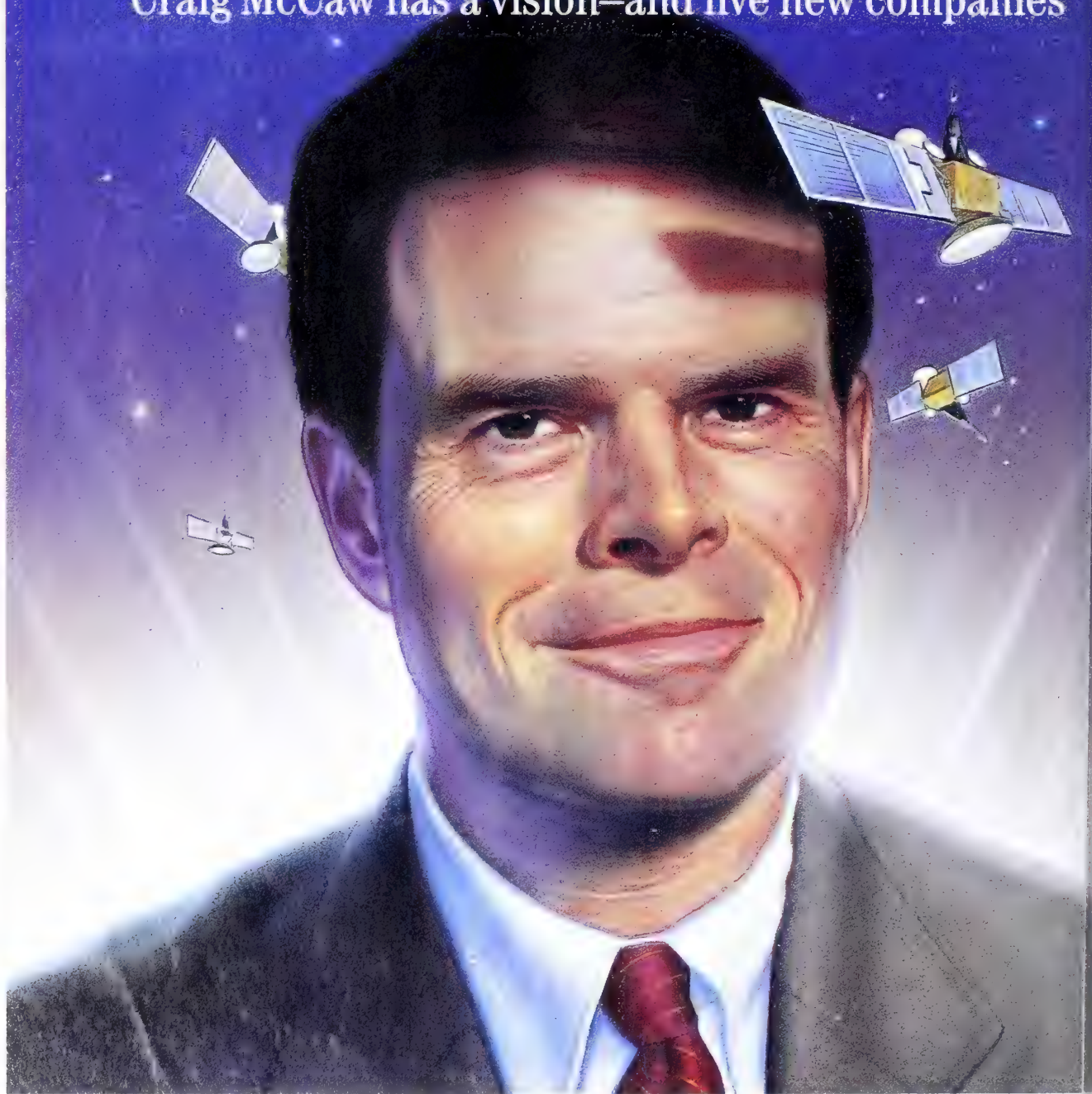
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COMMUNICATIONS

THE PROPHET OF TELECOM

Craig McCaw has a vision—and five new companies



BY PETER ELSTROM

On a typical summer day at his corporate offices outside of Seattle, Craig O. McCaw is nowhere to be found. Instead, the reclusive billionaire who helped create the cellular industry is on his yacht, the Cellular One. His favorite spot to weigh anchor is deep in a bay called Desolation Sound, an hour north of Vancouver by seaplane. The closest town of any size is Campbell River, B.C.—a community of 8,851 that bills itself as the “Salmon Capital of the World.”

The perfect retirement? Not for McCaw. After selling his McCaw Cellular Communications Inc. to AT&T for \$11.5 billion in 1994, the wireless pioneer is back, at the age of 49, quietly building new businesses more furiously than ever. From his 77-foot yacht, he's juggling five new ventures with an even more ambitious goal than when he envisioned the cellular world: This time, he wants to spread the benefits of the Information Age around the globe and to all walks of life. “He's building a new telecom world. People don't realize it yet, but he's putting all the pieces together,” says Sanford Rich, senior vice-president at GEM Capital Management Inc., which holds stock in one of McCaw's companies.

What McCaw has been assembling is a new empire with staggering potential. He has major stakes in companies that will be able to deliver high-speed digital connections from almost anywhere—underground, atop skyscrapers, even space. His lofty goal is to offer the world's most complete array of communications services, including local, long-distance, wireless, and satellite connections. Just this year, he unveiled a cutting-edge company that would have a nationwide fiber-optic network with more capacity than AT&T, MCI Communications, Sprint, and WorldCom combined. “I'd just as soon be retired, at that doesn't seem to happen,” says McCaw with a wry smile. “We just keep having these ideas.”

He's only half joking. McCaw is the reluctant visionary in the world of communications. The entrepreneur seems to feel both blessed and burdened by what he calls “these ideas”—as if they're a mix of personal demons. He loves to be able to create services to make peo-

ple's lives better, but he hates much of the baggage that comes with empire-building. He abhors meetings, and he doesn't like going to the office much. “He's a free spirit,” says James L. Barksdale, Netscape Communications Corp.'s chief executive, who worked at McCaw Cellular. McCaw shuns publicity, especially since his 22-year marriage to his college sweetheart ended in a messy divorce last year. He refused to sit for a photo for this article, although he agreed to a rare interview.

Despite his reticence, McCaw's grand plan to build the next generation communications powerhouse is beginning to emerge. The names of his businesses say it all: There's Nextel, Nextlink, Nextband, and Internext. Only his 288-satel-

Nextlink and Nextel are likely to market lightning-fast data connections from Teledesic, which plans to be operational by 2003. Teledesic, in turn, will allow McCaw to plunk down a small Nextel wireless network in the middle of nowhere and carry traffic out via satellite, allowing him to serve regions none of his rivals could touch.

NEW-AGE EXEC. Nextband Communications LLC, a company McCaw launched just this year, will kick in much sooner. Next year, the company will offer high-speed Net connections over radio waves to offices that can't be reached economically by satellite or fiber. And Internext LLC, the 15,000-mile fiber-optic network McCaw is building in the U.S., will be one of the most sophisticated digital

communications systems going. Initially, it will have the capacity to handle some 300 million voice conversations simultaneously—more than take place at any one moment in the U.S. “It's like building a 1,000-lane highway,” says Wayne M. Perry, CEO of Nextlink. “You can do things nobody ever thought of before—like having one lane where you can drive your Ferrari 300 miles an hour.”

But McCaw doesn't want to cater just to Ferrari drivers. Indeed, this time he aims to make communications just as accessible to someone in a remote South American village as it is to someone in teeming London. Call him a New Age executive—an entrepreneur who

is as interested in righting social wrongs as he is in racking up profits. Some might even say he's downright odd. He once suggested to government regulators that they should reserve radio spectrum for telepathic communication. For years, he would hold his hands up to people in his office to feel their auras, says McCaw lieutenant Bob Ratcliffe. And last summer, after agreeing to help pay for the killer whale used in the movie *Free Willy* to be flown back to Iceland, he swam with the whale and called it “a high point of my life.”

McCaw has yet another radical notion. The former history major at Stanford University thinks the Industrial Age is “one of the low points of human evolution” because it has forced people to pile into cities, leaving relatives and friends behind. That has created shortages of space in urban areas and devel-

CRAIG McCAW

BORN Aug. 11, 1949 in Centralia, Wash.

EDUCATION B.A. in history, Stanford University, 1973.

FIRST JOB At 16, he agreed to sell cable subscriptions over the summer for his father's Seattle cable company. In exchange, he got to take his first flying lessons.

CAREER Expanded what was left of his father's cable TV business and sold it for \$755 million in 1987. With the backing of his three brothers, Craig built up McCaw Cellular and sold it to AT&T in 1994 for \$11.5 billion.

HIS RICHES Net worth is estimated at \$2.5 billion.

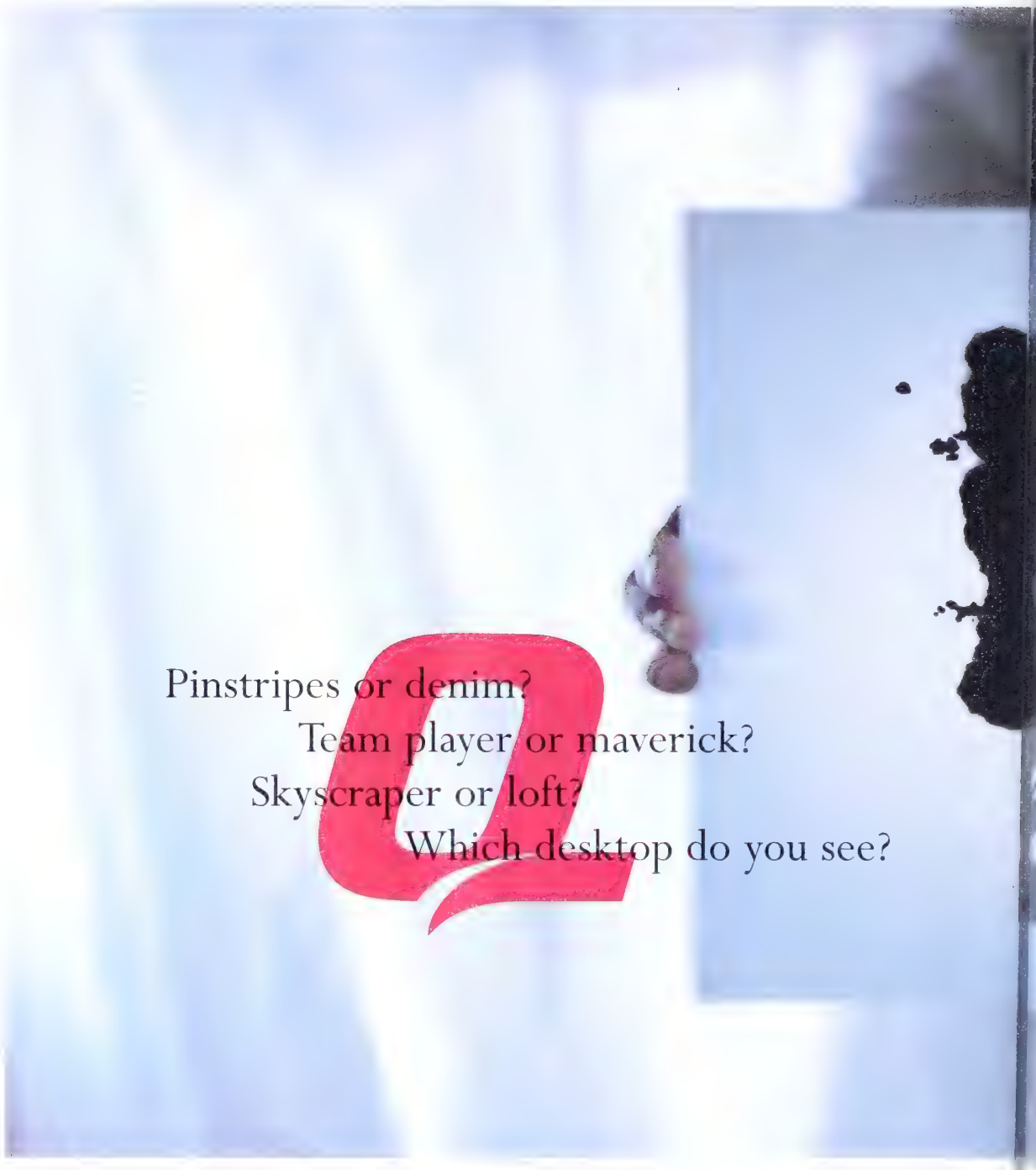
HIS TOYS A Challenger jet, a 193-foot yacht called Calixe, a 77-foot yacht called Cellular One, and several smaller boats.

PERSONAL His marriage to college sweetheart Wendy Petrak ended last year with an out-of-court settlement estimated at more than \$500 million. He married Susan Rasinski, a former San Francisco investment banker, in February.

lite venture Teledesic didn't get the “Next” label—perhaps because in 1994 it was the first piece to be founded.

The strategies of McCaw's most established companies are disarmingly simple: Selling primarily to businesses, three-year-old Nextlink Communications Inc. provides local phone service in competition with the Baby Bells, while the older Nextel Communications Inc. markets a cellular-like wireless service. Together, they serve 2.1 million customers.

But those initiatives are McCaw's Trojan horse. They provide him with aggressive sales forces that get him in the door with corporate customers. Once inside, the entrepreneur will try and sell Space Age data-communications services that could leave other telecom players in the dust. Already, Nextlink is working out how it can sell Nextel's wireless service to its customers. Later, both



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to EP Series

NEXTEL provides cellular-like service to 2 million subscribers and has been growing faster than any other wireless service provider in recent months. Its primary customers are businesses, but it hopes to expand into the white-collar market.

Revenues: \$1.8 billion
Capital Expenditures:
\$2 billion*



NEXLINK builds fiber-optic rings in cities to provide local telephone service to business customers. It currently operates in 18 metropolitan areas and plans to expand to 40 by the end of 2000.

Revenues: \$35 million* Capital Expenditures:
\$400 million*



McCAW'S NEW TELECOM EMPIRE

The entrepreneur is assembling the pieces of his next-generation communications company

INTERNEXT will connect Nextlink's cities and give McCaw tremendous long-haul capacity throughout the country. The original 24 fiber-optic strands will be able to carry a total of nearly 300 million voice conversations simultaneously. Internext will have the ability to add 432 more fiber strands in the future.

Revenues: Not yet operating
Capital Expenditures: \$1 billion

oped countries, while leading to a breakdown in the family structure. At the same time, Third World countries are losing their leaders of the future to developed countries. "The worst sort of imperialism is the brain drain of the best and the brightest," he says.

TOO PHILOSOPHICAL? So McCaw is out to change the course of the Information Age. Because information flows more freely than physical resources like steel or timber, it can be distributed to people anywhere—from South Africa to Siberia. By using Teledesic's satellites to extend the Internet, African artisans can sell sculptures directly to U.S. collectors, cutting out middlemen and making a profit, too. The migration patterns of the past

200 years—toward urban areas and developed countries—would stop. "The real potential of the Information Age is that people can live where they like," he says.

Does that make Teledesic an altruistic venture? "In any business, you want to have some socially redeeming value," says McCaw. But he insists the satellite venture will pay its own way, primarily by charging businesses for high-speed connections in remote locations. "We recognize that we can do something really good and, by the way, not have it viewed as some charitable project," he says. "It's absolutely the right thing for the world and a good thing for us."

Maybe so. But there are some who think McCaw has grown far too philo-

Scheduled to begin service in 2003, **TELEDESIC'S** 288 satellites will deliver high-speed data connections to any point on the globe. McCaw will target businesses at first, but his dream is to give people everywhere fast, cheap connections to the Net.

Revenues: Not yet operating
Capital Expenditures: \$9 billion



Jointly owned by Nextlink and Nextel, **NEXTBAND** uses wireless technology to carry voice calls or data over radio waves. It can cost as little as one-tenth the cost of Nextlink's fiber to connect businesses a few miles outside a city's downtown.

Revenues: Not yet operating
Capital Expenditures: More than \$140 million



sophical during his days in Desolation Sound. To be sure, his five major ventures are all compelling business ideas, and no other telecom mogul is attempting to string all the pieces together to deliver communications to every pocket of the globe. But unlike the days when McCaw was carving out new cellular ground, others also see the opportunities ahead. Now, McCaw faces competitors on every front, from scrappy IC Communications Inc. to the giant Bell

His ventures all carry substantial risk, and, with the capital markets in turmoil, the biggest hurdle may be persuading skittish investors to fork over the bundles of cash necessary to fund all the ventures. The numbers are daunting

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NETWARE 5

Bill Gates has invested \$10 million in Teledesic, while Saudi Prince Alwaleed has put in \$200 million

Teledesic needs to raise \$7 billion; Nextel plans to spend at least \$3.5 billion in 1998 and 1999; and Nextlink expects to spend \$1 billion this year and next.

The piece that's most vulnerable is the linchpin of his empire, Teledesic. While the system will cost at least \$9 billion, no one really knows how big the market for its services will be. Moreover, satellite launches are problematic. Globalstar Telecommunications Ltd. lost 12 satellites worth \$160 million in a Sept. 10 launch. And the Internet market that McCaw is targeting is going through tumultuous change. "If you tell somebody in this industry that you're going to deliver a service in five years, you hear a lot of low groans," says John W. Sidgmore, vice-chairman of rival WorldCom.

Yet McCaw isn't worried. He argues that the market for satellite services will be big enough for all the competitors—and that should help him attract capital. Merrill Lynch & Co. estimates demand for multimedia services via satellites will hit \$5.6 billion in 2003. "The challenges are not on the market side," insists Teledesic President Russell Daggatt.

McCaw has some marquee backers who agree. Microsoft Chairman William H. Gates III has chipped in more than \$10 million, and Saudi Prince Alwaleed bin Talal bin Abdulaziz Al Saud has invested \$200 million. In May, Motorola scrapped its own plans for a data-satellite network and took a 26% stake in Teledesic. Alwaleed expects the project will yield annual returns of 30% to 40%. "The real payoff is in the long term," he says.

BOLD. The confidence of such monied investors is bolstered by McCaw's track record. Back in the 1980s, analysts thought cellular would never become a mass-market service. McCaw was ridiculed for paying \$20 per potential customer for wireless licenses, driving his company deep into debt. Then McCaw sold his company to AT&T for about \$250 per potential customer, personally making about \$1.5 billion. "You don't cut Craig McCaw short," says Samuel Ginn, CEO of AirTouch Communications Inc., a Nextel

competitor. "He has the talent to see things that other people don't see."

That McCaw sees the world through wide-angle lenses reflects an upbringing that was grander than most. His father, J. Elroy McCaw, was a pioneer in radio and television who bought the Boeing mansion in the tony Highlands area of Seattle. Young Craig and his three brothers grew up with servants and a private cook. Elroy's biggest success was the purchase of WINS in New York City, which he turned into the country's first rock-and-roll radio station. He bought the station for \$450,000 in 1953 and sold

checks for the summer, all uncashed.

Later, tragedy struck. In 1969, 19-year-old Craig McCaw found his father dead of a stroke in their home at age 57. Creditors swarmed over Elroy's companies, and his estate was soon declared insolvent. The mansion and a Learjet had to be sold. Still, the McCaws weren't penniless: They owned the cable-TV company, Twin City Cablevision, and Elroy's life insurance brought them \$2 million.

After Elroy's death, Craig worked hard to fill his father's shoes. He took a year off from Stanford to help his mother straighten out the family's affairs.

When he returned to college, the Twin City general manager reported to McCaw in his dorm room. "Craig was always a lot more serious than the rest of us," says Larry Leisure, a Stanford classmate. After graduation, McCaw took over the cable franchise. "He had spent the most time with his father and was following in his footsteps," says Countryman.

In more ways than one, Craig McCaw has inherited his father's big-picture vision and bravado—he is comfortable borrowing huge sums of money to double his bets on companies. And like his father, vision, not detail, is his trademark. Even McCaw's biggest supporters say he is a "terrible" day-to-day manager. He does not like bird-dogging critical details, such as budgets. He's the ultimate hands-off leader—he sets a direction and then leaves execution to seasoned lieutenants. Daggatt once asked McCaw whether he should attend a communications conference. "How you waste your time is your business," McCaw replied.

Ironically, for one of telecom's top execs, he's a lousy communicator. He avoids public speaking and is known for blowing the punch lines of jokes. He's also dyslexic, so he doesn't like to read long documents. One person close to the shy, unassuming executive labels him "charismatically challenged."

Still, McCaw inspires almost worshipful loyalty from those around him. Teledesic co-CEO Steve Hooper and other



NEXLINK'S PERRY: "Building a 1,000-lane highway"

it for \$10 million in 1962. As a practical joke, Elroy McCaw sent the then 13-year-old Craig into the bank alone to deposit the check.

From the get-go, Craig McCaw wanted to be just like his dad. At age 16, he spent most of his summer trying to learn his father's business by selling cable subscriptions door-to-door for one of his father's companies. "He wanted to get his hands dirty," says Steve Countryman, a high school friend who worked with McCaw that summer. "He was not wild and crazy as a teen." One day, Countryman pulled open a desk drawer and found McCaw's pay-

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Shy and unassuming, McCaw doesn't like managing people day to day or even coming to the office

ers dumped senior positions at AT&T Wireless and took pay cuts to work for McCaw again. It helps that he has made many of those in his inner circle wealthy beyond their wildest dreams. Perry, for example, walked away with about \$125 million in the sale of McCaw Cellular.

But it's more than that. McCaw has the playfulness of a kid. With friends, he disguises his voice almost every time he calls them—Daffy Duck one time, British royalty another. He loves to do spontaneous things, like fly his helicopter down to Oregon for seafood dinners. In the office, he will get into squirt gun or Nerf ball fights. The day he sold McCaw Cellular to AT&T, he skipped out on media interviews in New York. Instead, he bought a Rockettes Barbie Doll at FAO Schwartz as a gift for the daughter of one of his top execs who had had to miss a day with his daughter for the first time since his divorce.

GOOD MOOD. It has only been since his own divorce last November that McCaw poured his energy into his new business ventures. McCaw and Wendy Petrak had grown apart over the years, friends say, and their differences were exacerbated once McCaw sold out to AT&T and the couple spent more time together. The separation dragged on for more than a year as the couple sparred over such issues as who would get control of their Hunts Point (Wash.) mansion. Finally, they reached a settlement giving Petrak more than \$500 million in Nextlink and Nextel stock.

McCaw's new wife, Susan Rasinski, has brought out a different side of the man, friends say. Gregarious and outspoken, the former San Francisco investment banker has made McCaw much more outgoing and social than he has been in the past. Today, he invites friends from his companies to his home and yacht more frequently, and McCaw, who is childless, loves having his nieces and nephews visit. "I think he's very happy now," says Nextel CEO Daniel Akerson.

The performance of his businesses is adding to McCaw's good mood. Nextel,

the most valuable of his holdings, at \$1.2 billion, has been on a tear of late. Since beginning to market service two years ago, it has zoomed to 2 million subscribers. Analysts figure revenues will rise from \$740 million last year to roughly \$1.8 billion this year.

Still, Nextel needs cash to keep the growth going. In the U.S., Akerson plans to spend at least \$1.7 billion this year and between \$1.2 billion and \$1.4 billion in 1999. Overseas, he will plow in

tages in the \$100 billion market: customer service and low prices. Michael Grabarits, owner of Pennsylvania's ExecuTrain Corp., which trains people to use software, is a case in point. One of his pet peeves with Bell Atlantic Corp. was that he never knew whom to call when something went wrong. "I called in to a bank of people," he moans. Nextlink solved that by assigning one service representative to his company, at the same time saving him 30% on his phone bill.

With its success so far, Nextlink is facing great expectations. The number of phone lines it sells hit 102,000 at the end of June, up 32% from just three months earlier. Revenues are expected to jump from \$57.6 million last year to \$275 million in 1999, according to Bear, Stearns & Co. Nextlink is building so rapidly, though, that its losses totaled \$129.3 million last year.

What are McCaw's chances for success? There's little question he will add to his fortune. His stakes in Nextel, Nextlink, and Teledesic are worth a total of \$2.3 billion, and the values of Nextel and Nextlink are sure to rise if the companies continue their hot growth. But to create a new communications goliath, McCaw

needs Teledesic. Without the satellite system, McCaw is left with a collection of me-too businesses.

That would be a cue for McCaw to repeat the past and sell out again. Nextel, for example, would fit perfectly with WorldCom, which focuses on businesses and has no wireless offering. "Craig always has a back door," says Barksdale.

McCaw knows his empire needs to be different. "There is a food chain," he says. "Time and technology are always driving you down the food chain and you need to innovate to stay up the food chain." Teledesic is his best shot at innovation. Without it, it'll probably take a bit longer for the Information Age to reverse the "low points" of the Industrial Age.

With Seanna Browder in Kirkland, Wash., and Roger O. Crockett in Chicago



CO-CEO: Steve Hooper took a pay cut to work with McCaw

\$300 million to \$400 million this year and next to expand the network. Yet analysts don't expect the company to start making money until 2001.

So far, investors are betting on McCaw. While the wireless industry is going through price-cutting, investors think Nextel will be somewhat insulated. The buffer: The company sells primarily to businesses, which rarely change carriers, and it offers a unique walkie-talkie feature called "Direct Connect" that allows an employee to push one button and talk instantly to some 100 co-workers. "What is underappreciated is their unique technology," says Michael Mahoney, a portfolio manager at GT Global Telecommunications Fund, a Nextel shareholder.

By contrast, Nextlink's local phone service is hardly unique. It does, however, have a couple of significant advan-

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A photograph of Bill Ford, a man with short brown hair and a light blue shirt, leaning against the side of a dark-colored vintage car. The car's steering wheel and a round headlight are visible on the left. The background is dark and out of focus.

Bill Ford, Henry's
great-grandson

CHAIR

William Clay Ford Jr. is fuming. The Detroit Lions, the football team he manages and co-owns with his dad, have just suffered a heartbreaking overtime loss to the Cincinnati Bengals—the second straight loss of the season. Disheveled and hoarse, he strides into the locker room and kicks a chair in disgust. “I’m sick of losing,” he rumbles. “I hate this.” But as sportswriters gather around him, he cools off, praises his coaching staff, and says only they will decide whether to bench quarterback Scott Mitchell for throwing two critical interceptions. “It’s not all Scott’s fault today,” he says of the 34-28 loss.

Bill Ford Jr. is about to have a lot bigger problems than interceptions to worry about. On Sept. 9, he was named to succeed Ford Motor Co.’s Alexander J. Trotman as chairman of the automotive giant founded by his great-grandfather Henry Ford nearly a century ago. Running a football team, of course, is small potatoes compared with overseeing the world’s second-largest carmaker. But the chair-kicking episode gives a glimmer of what Chairman Ford will be like.

STRONG HAND. Known for his cordial, gentlemanly manner, the 41-year-old Ford is nevertheless a demanding boss. As soon as Bill Jr. was given more control over the Lions in 1996, he wasted little time firing Coach Wayne Fontes after a string of disappointing seasons. And, diplomatic comments to sportswriters aside, in private Ford makes clear he means to get to the bottom of the latest defeat. “I’d like to talk to Scott to find out what happened on those last two interceptions,” says a now-calm Ford.

Football may be Bill Ford Jr.’s passion, but the automobile industry is in his blood. As heir to a family dynasty that still controls 40% of Ford Motor, Bill Jr.’s life has been wrapped up in the car company’s fortunes from the moment he was born. Perhaps more than any other American family—and despite its oft-

noted propensity for scandal, intrigue, and alcoholism—the Ford family has managed to keep a strong hand in the business from one generation to the next. If ever a family ranked among the aristocracy of American business, it is the Fords.

Now, it falls to Bill Jr. to carry the torch. The first Ford to hold the chairman’s post since his uncle Henry Ford II stepped down in 1980, Bill Jr. has held a succession of jobs since he joined the company straight out of college in 1979. From a low-level financial analyst to a vice-president for truck development, he has worked—if only briefly—in nearly every corner of the company as he moved through a career path clearly designed as an apprenticeship for a chairman-in-training. Now Ford, who has emerged as a force on the Ford Motor board in recent years, vows to lead and direct an industrial giant and its 363,892 employees.

Bill Jr. won’t be running the \$154 billion carmaker alone. In an unusual power-sharing arrangement, Jacques A. Nasser, 50, the company’s hard-driving automotive president, will become CEO on Jan. 1—at the same time Ford takes over as chairman. The pair are inheriting their jobs from Trotman, 65, who is leaving a year earlier than planned. With his job largely done,

Trotman says he’s ready to step down. His global reorganization has paid off, making Ford the world’s most profitable carmaker.

The new duo aims to keep it that way. Nasser, the scrappy, hard-nosed cost-cutter who is widely credited with Ford’s turnaround, will run day-to-day operations. Although Bill Jr.’s task of setting long-term strategy is harder to define, he insists he’ll be no mere figurehead. Every working day, he will be at company headquarters in Dearborn, Mich., he says, sitting at the massive burled-walnut desk that belonged to his grandfather, Edsel B. Ford. Nasser will sit in an adjoining office.

Both insist they will get along fine. The pair go back a ways. When, in 1984, Bill Ford

Cover Story

His Roots, His Role, His Priorities



Ford



THE FORD LEGACY

Few family dynasties in Corporate America can compare with the stormy mix of creative genius, business acumen, noblesse oblige, infighting, scandal, and boardroom feuding of the Fords. Nearly 100 years after the first Model T rolled off the assembly line, the family still controls 40% of the company. On Jan. 1, 1999, the fourth generation will take the wheel, as Bill Ford Jr. becomes chairman

◀ **HENRY FORD (1863-1947)**
CLARA BRYANT

Ford Motor founder, he ran the company from its inception in 1903 to 1945. An inveterate tinkerer who once worked for Thomas Edison, he was an early champion of the gas-powered engine. But he was best known for creating the first moving assembly line. Although he was a pioneer in mass-producing affordable cars, his stubborn refusal to diversify beyond the Model T and his bloody battles with unions pushed his company to the brink of disaster. Famously insisted that customers could have any color car "so long as it is black." He favored social engineering, building schools, roads, and hospitals—he also insisted on employee cleanliness, thrift, and sobriety.



HENRY FORD II
(1917-87)
ANNE McDONNELL

Left Yale after his father's death to join Ford in 1943. CEO from 1945; chairman 1960-80. An autocratic leader who fired three presidents, he revived the company after World War II. Settled fights with: "My name is on the building."

BENSON FORD
(1919-78)
EDITH McNAUGHTON

Joined company in 1943. Became a director in 1945. Held jobs in Lincoln-Mercury and dealer operations until his death in 1978. Gradually receded from business to spend his time yachting, as his brother Henry II shut him out.

■ **CHARLOTTE FORD**
(1941-)



Agitated in 1989 for a greater Ford family presence on the board. Publishes *Charlotte Ford's Book of Modern Manners*.

■ **ANNE FORD**
(1943-)

■ **EDSEL FORD II** (1948-)

Joined company in 1974; board in 1988. As eldest male cousin, was once top contender to run the company. Became president of Ford Motor Credit in 1991 but left in April, 1998, to pursue private interests.

■ **BENSON FORD JR.**
(1949-)



Living in Southern California and racing cars, he hired attorney Roy C. Loe to sue the family trust after his father's death in 1978, demanding \$10 million and a board seat. Raised a ruckus from the floor at Ford's 1979 shareholder meeting. Since reconciled with the family and returned to take a Ford marketing job between 1980 and 1995. He now sponsors a motorcycle team and races formula cars.

■ **LYNN FORD ALAND**
(1951-)

EL BRYANT FORD (1893-1943) ANOR CLAY

Ford's only child, he was president from 1919 to 1943. A creative manager, he was bullied and undermined by his son. His son Henry II eventually made his name synonymous with the company by naming the Ford after him.



WILLIAM CLAY FORD (1925-) MARTHA FIRESTONE

as the family prankster, married interior designer Buhl Ford II (no relation) in 1943. A museum curator, her own collection includes paintings by Van Gogh, Renoir, and Picasso.

BUHL FORD III

to start a movie business. Worked for Ford marriage from 1978 to 1993.

NOR CLAY FORD (1946-)

PHINE CLAY FORD (1949-)

ED BRUSH FORD (1950-)

Shunned the family business, he became a Hare Krishna, and renamed himself Ambarish Das. Donated a part of his fortune to a Grosse Pointe man to an ashram. Active in corporate charities.

WILLIAM CLAY FORD (1925-) MARTHA FIRESTONE

A director since 1948, he ran Continental car division until brother Henry II closed it down in 1956. Named vice-chairman in 1980 when Henry bypassed him to name a nonfamily chairman. Became head of key finance committee after Henry's death in 1987.

MARTHA PARKE FORD MORSE (1948-)

SHEILA FIRESTONE HAMP (1951-)

Currently active in Ford corporate charities.

WILLIAM CLAY FORD JR. (1957-)



Hired at Ford in 1979 straight out of Princeton. Joined board in 1988. Rotated through 15 jobs before leaving management in 1994 to run the finance committee.

ELIZABETH KONTULIS (1961-)

reported to Nasser, "one of his first requests was: 'Don't treat me any differently,'" Nasser says. "And I didn't." Today, "Bill leads the board, and my job is to run the company."

Fellow board members say Ford earned the top job in the past three years through his forceful performance as chairman of the board's powerful finance committee, which controls the company's \$22 billion cash reserves. Director Carl E. Reichardt, former chairman and CEO of Wells Fargo & Co., says that when Ford first joined the board, at 30, in 1988, he went through a "quiet period" while he learned and matured. But now his words carry weight. "When he speaks, people listen," says Reichardt. "He's no clerk. He's a thoughtful, well-educated young man who doesn't wear his stripes on his sleeve."

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Indeed, signs of the new chairman's influence are already evident. Board insiders say he played a key role in Ford's recent decision to back out of the bidding for Korea's insolvent Kia Motors. Worried because the deal would have required taking on Kia's massive \$7 billion debt, Ford pushed fellow directors to walk away. "I'm not the shy, retiring type," says Ford.

With the Kia deal off, Ford's immediate and most important job is figuring out what to do with all that cash. Ford says he's still shopping for a global auto business—but nothing as big as the pending marriage between Daimler-Benz and Chrysler Corp. "Ford has enough products and global breadth that we don't need to rush into anybody's arms," he says.

Wall Street is watching closely. Stephen J. Girsky, a Morgan Stanley Dean Witter analyst, figures Ford has four choices: a stock buyback, a dividend increase, an acquisition, or an investment in the company's dealer network. Ford has "a lot of extra cash burning a hole in their pocket," says Girsky. "How they use it will tell us a lot."

"JAC THE KNIFE." Even more revealing will be how Ford and Nasser respond to another imminent problem: Japanese sport-utility vehicles such as the popular Lexus RX300 are beginning to threaten Ford's fat profits. Analysts say nearly half of Ford's annual \$6.9 billion 1997 profits came from hot-selling sport-utilities such as the Ford Expedition. "You can't prevent others from encroaching on the parade," says Ford. "We just have to keep pushing and coming out with excellent products."

In the meantime, Bill Ford will serve as Ford's link to Wall Street and other large investors, whom he intends to meet with regularly. And he will make a point of walking the hallways at Ford to keep a finger on the pulse of middle management. "I never want to be sitting in a plush office with the door closed and not out seeing people," says Ford.

Ultimately, Ford's success may rest on his ability to manage one man: partner Jacques Nasser. As Ford's automotive president since October, 1996, the blunt-talking Australian has transformed Ford from struggling with the worst profit margins in the business to scoring record earnings last year—surpassing General Motors Corp. Nasser has slashed \$4.3 billion in costs in the past 18 months—thus living up to his nickname, "Jac the Knife"—and this fall he will show a further 10% of Ford's 53,000 salaried staff the door. Nasser also has a flair for car design and has reinvigorated Ford's overseas operations. "Jac's been the catalyst," says Lehman Brothers auto analyst Joseph S. Phillippi, who believes keeping Nasser is crucial. "Jac's the general," he says.

Both executives are opinionated and strong-willed, and they admit they have differences. For example, Nasser doesn't believe he will live to see the death of the internal combustion engine, while Ford believes he will. "If we agreed on every single issue, then we wouldn't be getting the benefit of his perspective and my perspective," says Nasser. Adds Ford: "We'll thrash out our differences thoroughly, but behind closed doors."

Still, one large Ford investor sees problems ahead if either

one strays onto the other's turf. "If Jac does a bang-up job by hitting on all cylinders, it is going to be hard for Bill Ford to do more than run the board, make management hires, and run the Lions," the investor says. On the other hand, "if Bill starts to get in Jac's way, then guys like GM will probably be lining up to say, 'Jac, why don't you come over and work for us—and be chairman.'"

Indeed, the two-for-the-road power-sharing arrangement has a history of failure at Ford. Billy's uncle, the imperious Henry Ford II, ran Ford with an iron fist for 35 years and

Cover Story

was legendary for clashes with his managers. Most famously, he fired Lee A. Iacocca in 1978 rather than entrust him with the family legacy. And he frustrated his brother William Clay Ford Sr., Bill's father, now 73, at every turn.

Unquestionably, Bill Ford's appointment to the chairman's job is a victory—and vindication—for both Bill Ford and his father. Bill Jr. now becomes the steward of the Ford clan's considerable fortune, estimated to be worth more than \$5 billion. Much of that fortune—about \$2 billion—is held by his branch of the family. "The family has more at stake in the welfare of the company than anyone else," explains Bill Sr.



the last surviving grandson of Henry Ford. "This ensures that the company won't go off and do something screwy."

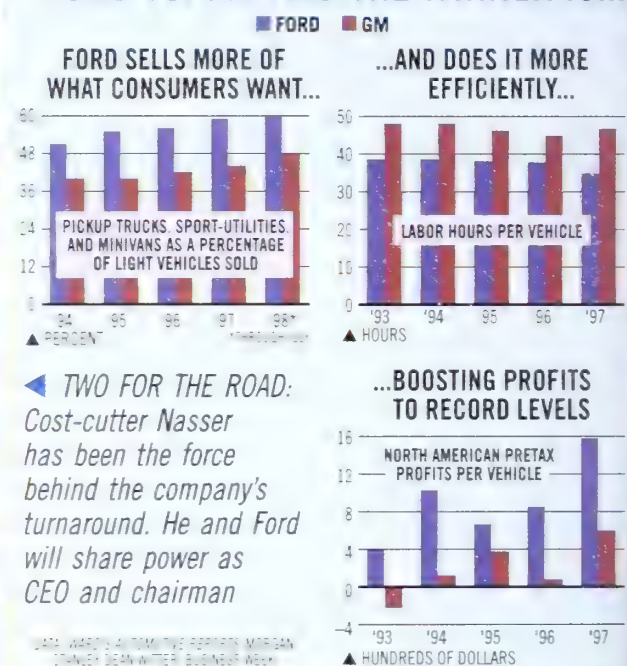
Henry Ford, though, just might have found his great-grandson, Bill, a tad peculiar if the two had ever met. Despite his lineage, Bill Jr. is nothing like the old-model auto baron. Rather, he is a New Age industrialist. He calls himself a "passionate" environmentalist, who wants to make green policies as integral a part of Ford as is quality. "For us to succeed, we have to be seen as an environmental company," he says. That's why he's so convinced he'll see the demise of the internal-combustion engine. "Someday, it will be gone," he says, replaced by electric cars powered by fuel cells or some other kind of clean fuel.

Ford also has some awfully high-minded notions for his company's future. Profits are important, but "a great company goes beyond that and makes the world a better place."

he insists. He envisions a modern-era version of his great grandfather's legacy of social engineering: He hopes to use Ford's financial and social clout to educate the poor and help clean up the environment. Already, he has been instrumental in Ford's financing the construction of 100 kindergartens and elementary schools in Mexico. Ford insists his views make good business sense. "I'm not going to be some madman running around with an open checkbook," he insists. "There's no incompatibility between doing the right thing and making money."

Still, Bill Ford knows as well as anyone else that his company's profits come largely from sales of outsize pickup trucks and sport-utes such as the giant Lincoln Navigator—auto that have been widely criticized as gas-guzzling polluters. And with Nasser's strong presence a comforting counterweight, Wall Street isn't yet overly concerned about Ford's social agenda. "At the end of the day, we want the stock to go up and Bill Jr. wants the stock to go up," says analyst Girskey. **DRIVING A SEMI.** Within the company, Ford's wide-eyed enthusiasm and boyish looks led to resentment as he climbed the corporate ladder. And some executives at the auto maker wonder whether Bill Jr. has really paid his dues. Others disagree. Ally and adviser Peter J. Pestillo, Ford executive vice president for corporate relations, says: "Whatever advantage

FORD VS. GM: AND THE WINNER IS...



he has as a member of the family he paid for dearly.

Ford is sensitive to being thought a dilettante. A few years back, he asked people to stop calling him Billy, his childhood nickname. And he has often gone the extra mile to compensate for his lineage. In 1989, when given a mundane assignment in heavy-truck engineering, Ford went to driving school and got a license to drive big 18-wheelers. His final exam required him to haul a load round-trip from Detroit to Toledo. "I recognize that there are those who think this job was handed to me," he says. "But I was under the microscope every step of the way. I had to have drive and ambition because people were looking for me to fail."

Despite Ford's privileged background—or maybe because of it—he developed into a ferocious competitor. On fishing trips with his three closest friends, Ford usually bags the biggest

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catch. "I define a good day of fishing as just being there," says Steve Hamp, Bill Jr.'s brother-in-law and a fishing buddy. "His definition is being there but also producing. He's always got a couple of buckets that he's trying to fill."

His competitive streak was nurtured growing up in a branch of the Ford family that made few headlines. In contrast to the fractured home life that many of his cousins endured, Bill and his three sisters thrived in their quiet, unremarkable household, bringing home good grades and earning laurels in sports. Their parents, Bill Sr. and Martha Firestone Ford, the tire heiress, tried to create as normal a world as possible given their family name and huge wealth.

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The family had no bodyguards or chauffeurs. Bill's mom made sure to drive him across town so he could play hockey with kids from far more modest backgrounds. Recalls teammate Ed Sadorski Jr., who played with him when both were teens: "He didn't shy away from the rough-and-tumble stuff."

Those games stood Bill in good stead later when he went away to the Hotchkiss School in Lakeville, Conn. Childhood pal Stephen Phinny remembers him as a terror on the soccer field who held his own in the raucous fights that broke out between rival prep schools. Bill got another lesson in toughing it out by watching his dad's football team lose year after year. The Detroit Lions, in fact, have not won a championship in the 34 years Bill Sr. has owned the team. After every Lions loss, young Bill listened to long-suffering fans howling at his father on sports radio. "It hurt, and I hated it," he says.

But it was the classroom, not the playing field, that counted most in the family, and Bill Jr. excelled there, too. At Princeton University, where he met his wife, Lisa Vanderzee, he majored in political science, writing his senior thesis on Ford's labor relations. In 1983, four years after joining the company, he took time off to earn a masters in management

at Massachusetts Institute of Technology. Bill also read deeply about environmental issues. He studied the works of nature author Edward Abbey and read Rachel Carson's seminal work, *Silent Spring*. As a teenager, he began volunteering on clean-water projects and became involved in Earth Day. "It struck a chord with me very young," he says.

Ford breezed through 11 jobs in his first decade at the auto maker as his father worked behind the scenes to make sure his son was getting the seasoning to lead Ford someday. Pestillo recalls that Bill Ford Sr. approached him in 1982 and asked that he put then 25-year-old Bill on Ford's bargaining team in talks with the United Auto Workers. "Bill Sr. had been on Ford's 1949 bargaining team and thought it was a great experience," says Pestillo. "He felt that if you are going to lead the company, you have to understand labor relations."

The only operation Bill ever ran at Ford was the company's tiny Swiss business. To test his mettle, Pestillo sent him there in 1987 to fix Ford's struggling operations. Bill Jr. did turn the unit around, boosting profits and putting Ford's top local dealer out of business because of poor performance.

GRIEVANCES AIRED. Back home, though, he soon encountered rough going. Donald Petersen, who was then chairman, marginalized him and his cousin Edsel Ford II, then 39, after they were named to the board in 1988. Petersen refused the "Ford Boys" committee assignments. "We felt penalized for our last names," Bill recalls. After Edsel and Bill went public with their unhappiness, Petersen relented and allowed them a more influential role. Following the family dustup, Petersen retired early, in 1990.

The two cousins were already viewed as rivals for the top job. As Henry II's son and the eldest male of the fourth generation, Edsel, 49, was long thought to be the favorite. But Bill's rise was assured when in 1995 he took the chairmanship of the board's powerful finance committee, a post created by Henry II to assure the family complete control of the company.



WILLIAM CLAY FORD JR.

BORN 1957, Detroit

EDUCATION BA 1979, Princeton; MS in management 1984, MIT

FAMILY Married to Princeton classmate Lisa Vanderzee. Two daughters, ages 13 and 11, and two sons, 7 and 3.

BEST THING ABOUT GROWING UP A FORD In addition to the family's 40% stake in the auto company, his father owns the Detroit Lions. "What cooler way to grow up for an American boy than to be around cars and football?"

WORST THING ABOUT BEING A GROWNUP FORD "Whenever I'm at a party, people are always telling me either to get a new quarter-back or make the Taurus backseat bigger."

DIFFERENCE BETWEEN THIRD AND FOURTH GENERATION His dad and two uncles hashed out business over the dinner table. The 13 cousins in Bill's generation meet just twice yearly.

FAMILY MISTAKES HE WILL TRY HARD TO AVOID He won't be as eccentric as his great-grandfather, company founder Henry Ford, or as imperious as his uncle Henry Ford II.

WILL HIS CHILDREN RUN FORD SOMEDAY? "I won't push them into it. My father didn't push me."

WHAT KIND OF CAR HE DRIVES A Ford concept vehicle known as the Rox. It's a bright yellow Ford Expedition with a pickup-truck bed.

HOBBIES Fly-fishing, hockey, tennis, tae kwon do, coaching his kids' soccer, collecting Civil War documents.

re strings. Meanwhile, Edsel is said to have clashed with ex Trotman, and his advancement in the company stalled. Edsel retired in April after 25 years at the company, the seven years as president of Ford's auto-lending unit, Ford Credit. Now the new chairman would like him to return. "The door is open," says Bill Jr. "I'm going to plead with him to get as involved as he wants." Edsel appears interested. "I'm glad he said that because he knows how much the company means to me," responds Edsel. "When the time is right, I'll sit down and discuss" it with Bill Jr.

A FLAIR FOR FOOTBALL

Managing the Detroit Lions, which he co-owns with his father, is Bill Jr.'s passion. But he is also passionate about the environment and aims to bring green policies to Ford. He says a great company is one that "makes the world a better place"



The family can continue to exert absolute power at Ford because they stacked the deck in their favor when they took the company public in 1956. Henry Ford II and his three siblings established a special "class B" stock that only family members can hold. One class B share's financial value is equal to a share of Ford common stock—but it has eight times the voting rights. Today, the Fords own 72 million class B shares.

Bill Sr. and Bill Jr. together control more than 26% of the class B shares, worth \$871 million. They also hold two of the family's three seats on the company's 11-member board.

Indeed, the Fords have avoided the erosion of fortune that splintered other dynasties. They have amassed a purchase price, and they acquire Ford common stock to trade with family members who need to liquidate class B shares for estate taxes or other expenses. That's why Bill Jr. says the family is worried about losing its voting power. "People in our family are buyers, not sellers," he says. What's more, the 13 siblings in Bill Jr.'s fourth generation meet twice a year to review the family holdings. And a special voting trust has been established by the family so they can vote their shares in unison. "We're a very cohesive family," says Bill Jr. "There's a great sense of tradition and responsibility in this family."

LDREN FIRST. Recently, Bill Jr. has emerged to join older siblings Edsel and Charlotte Ford as leaders of the fourth generation, says brother-in-law Hamp. "Bill, Edsel, and Charlotte have worked hard to develop a sense of unity and keep the group focused," says Hamp, president of the Edison Institute. And Bill plays a special role in family meetings: "He's a lot of fun, and he keeps things rolling," says Hamp.

Even with his heavy new burden of responsibility, Bill Jr. insists he will keep balance in his life. He readily confesses that he would always "rather be outside than indoors." And he shares his love of nature with his wife and four young

children. As a family, they camp, hike, and ski whenever they can. Like his parents, Ford is immersed in the lives of his two daughters and two sons, who range in age from 13 to 3. He coaches their soccer teams and likes to clown around for their friends whenever they visit. "My children keep saying that all the kids in the neighborhood like to come to our house because they find me entertaining," he says. "We're rarely serious around our house." Like a true '90s dad, Bill Jr. vows that even the chairmanship of Ford Motor Co. won't keep him from his children. "I will never

give up any involvement in their lives," he says.

Reluctantly, he's already had to cut down on his next greatest passion as an adult: a Hemingwayesque obsession with fly-fishing. Every chance he gets, Ford travels the world in search of the perfect fishing hole. He even co-owns a fly-rod company. A few years ago, he and his friends found themselves in the Amazon casting for peacock bass and catching a few piranhas. Eventually, they were chased from their paradise by torrential rains and a pesky anaconda that attacked one of their guides. Recalls longtime friend Ralph Booth: "We made a mutual decision: We've caught enough fish. Let's get out of here."

Ford also dabbles in Eastern philosophy and reads Buddhist texts. A strict vegetarian, Ford shuns alcohol and believes in the curative powers of alternative medicine. "I've seen an acupuncturist, an herbalist, and I do yoga," says Ford. He also practices the martial art tae kwon do. "I try not to drink," says Ford, whose father and uncles were afflicted by alcoholism. "My personality doesn't improve a lot when I drink." That's not the only lesson he's drawn from the family history. "Fame, fortune, and power really hold no allure for me," he says. "I grew up with them, and I've seen them make so many people miserable. I know they don't bring happiness."

Back on the sidelines, just before the Lions' crushing loss to Cincinnati, William Clay Ford Sr. talks of how proud he is that his son has reached the top in the family company. He once warned his son of the heartache Ford Motor Co. can give a family member. Now he just wants Bill Jr. to know that his old man is watching. "Hopefully, he'll do a good job," chides Bill Sr. "If he doesn't, I'll cut his allowance. He's too big to spank." But those who know Bill Jr. suspect he'll be the one to kick himself the hardest should he fumble in his bid to keep one of America's great industrial dynasties going for yet another generation.

With Kathleen Kerwin in Detroit



BERNARD
WILLIAMS

THE MONEY MACHINE

Why George Steinbrenner may be tempted to sell the New York Yankees

BY ANTHONY BIANCO



Outside Yankee Stadium, an August sun is broiling the Bronx. Inside the executive offices of the New York Yankees, the air conditioning is set somewhere below Arctic, overmatching even George Steinbrenner's hot-blooded constitution. "It's cold in here," Steinbrenner complains.

"Want me to turn off the air conditioning, sir?" offers an aide.

Steinbrenner leaps from his chair, strides across the room, and peers up at an offending air vent on the ceiling. "I'll stop it," he growls and draws a fist back behind one ear, a caricature of himself. Steinbrenner holds the pugilistic pose for a second, then drops his arm, and retakes his seat. "Where were we?" he says brightly, a smile playing at the corners of his mouth.

Sports Business

George M. Steinbrenner III, the Yankees' famously combative principal owner, has been pulling his punches all summer long. He hasn't harangued his manager or reproached a player for weeks now. He has stayed out of the clubhouse and more surprising still, out of the tabloids. "George and I fight like hell, but not this year," says Arthur Richman, a senior adviser to Steinbrenner. "This year he's been an angel."

At 68, Steinbrenner remains a compulsively competitive man of emphatic opinions and nearly uncontainable energy. But he has had the good sense to realize that indulging his penchant for controversy would only detract from the extraordinary performance of the Yankees in what is truly a baseball season for the ages. Besides, the Boss is preoccupied with weighty issues of business and family. After 25 tumultuous years, he has reached a critical juncture in his ownership of what might well be the most valuable sports franchise in America.

For starters, the Yankees' current \$486 million local television contract—the foundation of the team's prosperity since it was signed in 1988—expires in less than two years. While Steinbrenner pronounces himself pleased with the performance of the current rights holder, Cablevision Systems Corp.—“I consider them like partners,” he says—he is weighing many options. James L. Dolan, Cablevision's president and chief executive, says that he “is open to any ideas that Mr. Steinbrenner may have.”

At the same time, Steinbrenner is grappling with the financially critical and politically loaded issue of where the Yankees will play after their Yankee Stadium lease expires in 2002. (The team holds options that could extend the lease to 2012.) The “House that Ruth Built” opened in 1923 and was remodeled in the mid-1970s. A second overhaul is a possibility, as is an entirely new stadium in the Bronx.

But Steinbrenner, who has been bad-mouthing Yankee Stadium and the Bronx for years, is entranced by visions of a deluxe \$850 million stadium in midtown Manhattan.

A swanky new ballpark in the very heart of the nation's corporate and media capital could well be a revenue machine the likes of which U. S. sports has never seen. But for Steinbrenner, the issue is as much pride as money. “George has a firm, almost visceral belief that the current stadium and the location is wholly inadequate,” says David W. Sussman, who stepped down a year ago as executive vice-president and chief operating officer of the Yankees to join MTV Networks. “The state of the art has so far eclipsed what the Yankees have to offer that he views the stadium as a huge source of discomfort and even embarrassment for the fans.”

Finally, circumstances are conspiring to force Steinbrenner to think more seriously than ever about selling the Yankees. Cablevision, which already owns the New York Knicks and New York Rangers, is expected to try to preempt the TV rights negotiations by making a bid to buy the Yankees outright. “I think they'll go to George with a number calculated to shock him with its size,” says Neal H. Pilson, a former president of CBS Sports, who now runs his own Manhattan consulting firm.

MYSTIQUE COUNTS. Earlier this season, Rupert Murdoch's News Corp. bought the Los Angeles Dodgers for \$311 million, the most ever paid for a baseball team. Unlike the Dodgers, the Yankees do not own their stadium or the land around it. Even so, most experts attach a higher value to the Yankees, and not only because they play in the nation's most lucrative media market. The Yankees are the Yankees—the pin-striped embodiment of baseball tradition, the team of Babe Ruth, Joe DiMaggio, and Mickey Mantle. By most estimates, the Yankees would fetch at least \$500 million in a sale and perhaps as much as \$800 million.

Steinbrenner has frequently compared the Yankees to the

Where the Money Comes From*

	MILLIONS
NET TICKET SALES	\$35.0
LOCAL TV AND RADIO	47.5
MERCHANDISE AND PROMOTION	20.0
LUXURY SUITES	2.5
POSTSEASON**	10+
OTHER***	40.0
TOTAL	155+

* BUSINESS WEEK estimates for 1998

** Assuming a World Series appearance

*** Mainly from Major League Central Fund

DATA: BUSINESS WEEK

Molloy quit the team a year ago and now is divorcing his wife, the former Jessica Steinbrenner. Another son, Harold 29, and son-in-law, Stephen Swindal, 43, still work for the Yankees and jointly hold the title of general partner. However, team insiders question the depth of their commitment to baseball—and the Boss's willingness to relinquish control.

Steinbrenner, as always, is keeping his dealmaker's cards clutched tight. Says Harvey W. Schiller, president of Turner Sports Inc. and a close friend of Steinbrenner: “If you don't know George, you might think he makes his decisions by the seat of his pants, but the fact is he does an awful lot of research. He's spent a huge amount of time in the last few years studying all the opportunities open to him.”

Whatever moves he makes, Steinbrenner will act from a position of financial strength, for the 1998 Yankees are poised to reap the biggest revenue bonanza in the history of the franchise (table). Most important, the team has broken the Yankee Stadium attendance record of 2,633,701, set in 1988, with eight more home games to play. Regular-season revenues should hit \$145 million, and a World Series appearance could fatten Steinbrenner's coffers by an additional \$10 million or more.

However, if the past is any guide, precious little of the

Mona Lisa and has vowed he would never sell. But a new stadium—wherever it might be located—would be a huge undertaking that could expose Steinbrenner to outsize financial risk and consume the better part of a decade. What is more, his attempts to groom a family successor have not gone according to plan. His eldest son, Henry 41, bolted after an unhappy apprenticeship and son-in-law Josep



It's Not Easy Being

TV BONANZA

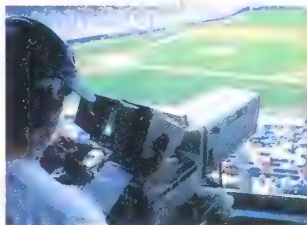
The Yankees' 12-year, \$486 million cable-TV contract expires in 2000. Steinbrenner is negotiating with Cablevision, the current rights holder, and may start his own channel.

SKY-HIGH COSTS

The Yankee payroll already is the second-highest in baseball at \$72 million. But Steinbrenner will have to shell out a lot more money to hang on to homegrown stars like Bernie Williams, Mariano Rivera, and Derek Jeter.

REVENUE-SHARING

The revenue-sharing plan baseball imposed in 1996 has cost the Yankees \$15 million, more than any other club. To pay the team has boosted ticket prices by 41%.



county will fall to the bottom line. Steinbrenner is a talkative man, except when it comes to the finances of his tightly held club. However, BUSINESS WEEK was able to obtain Yankee profit-and-loss figures for the years 1978 through 1990. During most of this period, the Yankees were little better than a breakeven enterprise. Even the \$40 million-a-year revenue cushion added by the MSG deal in 1988 wasn't sufficient to assure an annual profit. That year, the Yankees made \$27.8 million in ordinary income and posted a \$50 million gain in 1989, only to plunge \$1 million into the red in 1990.

The Yankees returned to profitability in 1992 and have remained in the black ever since, at barely. In the 1990s, as in the 1980s, the team has averaged just a few million dollars a year in net profit, according to a well-informed source. While attendance has fluctuated from year to year, salaries have risen exorbitantly. This year's payroll of \$22 million is the second-highest in baseball, trailing only the Baltimore Orioles. Says Steinbrenner: "I think it would surprise people to see that we're not a big moneymaker, at least not on a cash-flow basis." Or, as former Cleveland Indians owner Bill Veeck once liked to say: "You don't make money operating a baseball club. You make money selling it."

MAKING HISTORY. An investor group assembled by Steinbrenner bought the Yankees from CBS for \$10 million—\$8 million of it borrowed. The Boss put in only \$168,000 of the original \$4 million in equity but has since sunk millions more into

the club to buy out limited partners. With his wife, Steinbrenner now holds at least a 60% stake and sits atop what is probably the biggest capital gain in sports.

He also owns what is arguably the best team in baseball. The Yankee squad reached the vaunted 100-win mark on Sept. 4, earlier than any team in major-league history. Although the all-time record of 116 wins set by the 1906 Chicago Cubs is nearly out of reach, Joe Torre & Co. were 104-45 as of Sept. 16 and still had an excellent shot at breaking both the all-time Yankee record of 110 wins (set in 1927) and the American League mark of 111 victories, held by the 1954 Cleveland Indians.

Who needs pennant races? Four years after a players' strike ruined a superb season, this summer's historic individual performances are luring disgruntled fans back to the ballpark in droves. With two more seasons remaining on the existing contract, labor peace is assured through

2000. Baseball's most pressing problem is the yawning revenue gap that separates rich clubs from poor. "Hope is being taken increasingly away from teams whose revenue base is just not large enough to support a winner," argues Peter A. Magowan, managing general partner of the San Francisco Giants.

The disparity in revenues is as much a function of stadium economics as market



The Boss...

ATTENDANCE

1998 Bronx Bombers have set a new team attendance

and yet rank high in tickets sold among Major League teams. While, Atlanta, more, Cleveland, Denver, and cities with



lowtown stadiums sell out frequently.

STADIUM

Steinbrenner covets a new stadium in midtown Manhattan. Rudy Giuliani supports the notion, but many New Yorkers think of Yankee Stadium as hallowed ground and the team to stay in the Bronx. A fall referendum

SUCCESSION

Steinbrenner has been talking up one succession plan or another for more than a decade but still holds tightly to absolute power at age 68. Hal Steinbrenner, 29, and son-in-law Stephen Swindal, 43, dutifully work for the Yankees, but without the Boss's verve. Increasingly, it appears that the Steinbrenner Era will begin and end with George III.

CASHING OUT

Steinbrenner has rebuffed many offers for baseball's most valuable franchise.

But Cablevision is likely to tempt him with the most lucrative bid yet.



HAROLD STEINBRENNER



STEPHEN SWINDAL

size. Baltimore, for example, is not among the largest major-league cities, but the Orioles can afford its roster of talent because they play in Camden Yards, one of the retro-style, baseball-only, downtown stadiums that are now all the rage. The five franchises that lead in attendance this year—Denver, Baltimore, Phoenix, Cleveland, and Atlanta—all play in such stadiums. To Steinbrenner's annoyance, the Yankees ranked eighth in attendance per home game through August.

While a half-dozen cities are readying plans to build new baseball stadiums downtown, MLB is taking immediate steps to level the financial playing field. Baseball is phasing in a revenue-sharing plan that was adopted in 1996 and is designed to transfer \$70 million a year from have to have-not clubs by the time it is fully implemented in 2000. For each of the past two years, the Yankees made the largest revenue-sharing contribution—\$15.2 million, all told.

Yankee fans are helping foot the revenue-sharing tab. Since the 1995 season, Yankee ticket prices have risen by 41%, nearly double the rate of increase for MLB as a whole over this period. At \$20.51, the cost of the average Yankee ticket far exceeds the major-league average of \$13.60, according to the newsletter Team Marketing Report.

At the same time, Steinbrenner has gone in pursuit of new sources of revenue as aggressively as Yankee starter David Cone goes after hitters. In 1997, he was so determined to link logos with Adidas in a sponsorship deal that he filed suit against each of the other 29 teams and Major League Baseball Properties (MLBP) to force their acquiescence. The suit was settled out of court in April, on terms advantageous to the Yankees and Adidas. At \$93 million over 10 years, Adidas' sponsorship of the Yankees easily is the most remunerative in baseball and so wide-ranging that it amounts to brand melding.

NEW BALL GAME? The Adidas matter was resolved just in time for Steinbrenner to turn his attention to the less contentious but even more lucrative issue of TV rights. Yankee programming unquestionably is a hot commodity. Through August, Yankees game telecasts on Madison Square Garden Network (MSG), a subsidiary of Cablevision, have drawn 37% more viewers on average than last season, and ad revenues, by all reports, are strong. However, the competitive dynamics of sports TV in New York have changed to such a degree since the Yankees signed with MSG a decade ago that it is not obvious who has the upper hand in the latest rights negotiations: Steinbrenner or Cablevision's father-and-son team, Chairman Charles F. and CEO James Dolan.

In 1988, MSG had not yet been absorbed into the Dolans' empire but was owned by Paramount Communications Inc.

Cablevision did own SportsChannel New York, which broadcast Mets games and acquired the Yankee rights in 1982. Steinbrenner had signed a long-term deal but shrewdly insisted on an escape hatch. Come Nov. 1, 1988, the Yankees would have 30 days to reshuffle the rights. By the time 1988 rolled around, MSG believed that its very future hinged on breaking Cablevision's stranglehold on New York baseball. Steinbrenner named his price, MSG met it within 48 hours, and the deal was done before Charles Dolan knew what hit him.

Cablevision since has acquired MSG and further narrowed the field of potential rivals for Yankees broadcasts by allying itself with Fox Sports Net. (SportsChannel is now known as Fox Sports New York.) Asked if Cablevision's new marketplace power concerns him, Steinbrenner equivocates: "It's hard to tell. I don't think I do, not really, at this time."

Steinbrenner is not a captive of cable, in any event. He could bring new technologies—notably digital or satellite TV—into play to create a new channel or network around the Yankees. This would put him into the media business and require him to expand the leanly staffed business operation he maintains. Says the Boss: "It's a real possibility."

The Dolans long ago broached the topic of buying the Yankees in discussions with Steinbrenner and would surprise no one by putting a formal offer on the table. However, Steinbrenner has been rebuffing two or three unsolicited buyout offers a year for at least a decade, and many of his closest associates cannot envision him selling now. "So much of his identity and his energy is committed to the franchise," says one. "What would he be without it?"

The X factor in the Yankees' future is the stadium question. The large crowds the Yankees are drawing to the Bronx this season would seem to lengthen already long odds against a city-financed relocation. And with a referendum on the issue looming in November, a poll conducted by Quinnipiac College shows overwhelming opposition to public financing for a Manhattan stadium—even if it means losing the Yanks to Jersey.

To many fans, Yankee Stadium is an indivisible part of Yankee tradition. Although Steinbrenner proclaims himself a traditionalist, he takes a liberal, almost profane view of the issue. "Babe Ruth didn't run on this grass. Joe DiMaggio and Mickey Mantle didn't run on this grass because the stadium was totally redone [in the mid-1970s]," he says. "The only thing they may have used still here are the urinals and the lockers in the locker room."

Despite all the tough talk, would Steinbrenner really make good on his veiled threats to move across the river to New Jersey if he doesn't get his Manhattan venue? Is he willing to go down in history as the 1990s answer to Walter O'Malley, who was forever reviled in Brooklyn after moving the Dodgers to Los Angeles in 1958. "I think I take it a little more to heart than Walter O'Malley did," Steinbrenner says softly and then pauses. "I don't want to talk about that," he snaps. "So I won't."

With Mark Hyman in Baltimore

Sports Business



AFTER THE '96 SERIES George, with Rudy and Joe, yearns for a midtown stadium. But nostalgic New York voters may thwart him

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WILL CITIGROUP'S PARADE GET RAINED OUT?

Sandy Weill says no, but the Travelers-Citibank deal is making the market nervous

To see Sanford I. Weill, you wouldn't know the biggest deal of his career is coming under fierce attack by the market. The chief executive of Travelers Corp. seemed relaxed and enthusiastic on Sept. 15 as he described a "sleepover" he and John Reed, Citicorp's CEO, hosted the night before at Travelers' conference center in Astor Armonk, N.Y. It was a get-acquainted gathering for the 14 men and 2 women who have been chosen as board members of Citigroup, the company to be formed by the combination of Travelers and Citicorp.

As soon as the board members left for lunch, Weill prepared for the next group: Four Travelers and three Citicorp senior managers slated to run Citigroup, who were gathering for dinner along with their wives at the conference center that evening. "There is no chance that the Citicorp Travelers deal is going to fall through because of the

doings of anybody at Citicorp or anybody at Travelers," says Weill. "We're ready for full steam ahead when the Fed says we can go full steam ahead," he says, referring to Travelers' pending application with the Federal Reserve Board to acquire Citicorp.

Weill, a veteran dealmaker, doesn't sound like a man who might walk away from a deal, which was one of the rumors buzzing through the market. Yet much of the euphoria that accompanied Citigroup's announcement on Apr. 6 has turned to near panic. Along with the rest of the financial-services sector, Travelers and Citi stock have taken a bath, driving Travelers down from 73 to 43, and Citicorp from 180.87 to 103.

On Sept. 10, a share of Citicorp was trading for \$10 less than 2½ shares of Travelers, which is what Citi shareholders will get when the deal closes. (Travelers stockholders just keep their shares.) This gap, which has since diminished, reflected the belief that the deal might not get done (chart, page 112). "There has been huge trading based on rumors the deal was on the rocks," says Diane B. Glossman, banking analyst at Lehman Brothers. "I've gotten more calls from arbitrageurs in the last few days than I have had in many years."

SUBMERGING MARKETS. Another factor spooking the market is that Fed approval for the deal, which Weill originally said was to have come by Labor Day, has been delayed. Now, Weill says he hopes the O.K. will come by early October.

The fundamental question underlying the market jitters is whether the megadeal still makes sense. After all, Weill



WEILL AND REED: Travelers will be taking on Citibank's emerging-market exposure

As for backing out, Weill says: "I've never, ever thought of going back on a handshake or my word"

is taking on Citi's huge emerging-market exposure at a time when a scary number of these markets are in meltdown mode. "The worse things get in emerging markets, the more it seems like Travelers isn't getting a good deal by merging with Citi," says James K. Schmidt, a portfolio manager at John Hancock Financial Industries Fund, which holds stock in both companies. However, Schmidt says it would take an absolute collapse in Latin America to give Weill cause to pull out. "If Brazil becomes Russia, that's a reason. To me that would be a material unforeseen circumstance," says Schmidt.

ting on the Hill is that the Fed will "lean over backwards to approve this deal," says one lobbyist. Alan Greenspan is a longstanding supporter of financial-services deregulation. The Fed may be waiting to see if Congress acts on the financial-services reform bill before Congress' scheduled adjournment on Oct. 9. And the Fed may want to appear to deliberate about such a major merger "even if they were ready to approve this deal five minutes after it was proposed," says the same lobbyist.

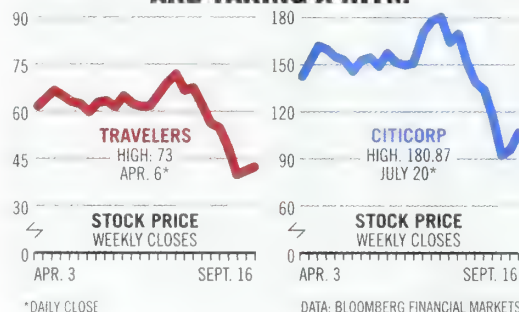
Any Washington subtlety may have been lost on New York traders. The gap widened between the value of Citi

near-term qualms. "As bad as things currently are in some emerging markets, things may deteriorate further," Ward says. He bought 100,000 shares of Citi at an average price of \$48 a share when it fell to \$140 in early August.

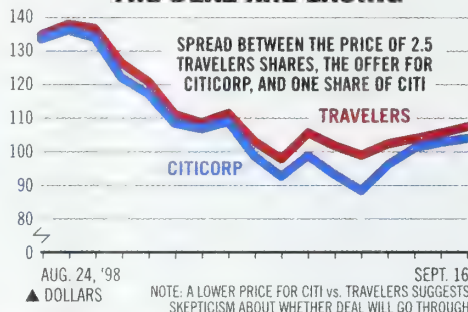
What could torpedo the deal? A substantial undisclosed credit problem at Travelers or Citi, speculates one bank analyst. One fear is that Citicorp's emerging-market losses could amount to more than the \$200 million in third-quarter Russian losses already announced. Unlike losses in Russian securities, which are quickly marked to market, hits in Asia and Latin America would prob-

bly involve loans that could take a long time to turn sour. "Credit problems, losses, combined with a big lag," says Tanya Azarchuk, bank analyst at Standard & Poor's Rating Service. "We have not seen the end of the Asian problem. We have only seen the beginning. It will take us nine months to see the beginning of Latin American problems even

CITI AND TRAVELERS ARE TAKING A HIT...



...BUT JITTERS OVER THE DEAL ARE EASING



Weill brushes off his critics. "I think that what's going on now more than validates what we did then," he says. He points out that Standard & Poor's Corp. and Moody's Investors Service have just affirmed or upgraded Travelers and Citicorp units. The deal's logic still stands, he says. Once the largely domestic Travelers bought the more international Salomon Inc. in 1997, he realized the combined firm was still too small. "I said, we're global, but we should be much more diversified, and we should be much stronger. And who the heck is the best company to go and talk to that can withstand the vicious cycles" in international markets, says Weill.

INSTANT APPROVAL. As for Travelers backing out of the deal, forget about it. "I've never, ever thought of going back on a handshake or my word," says Weill. "When you do, you're never going to be able to do the next deal." That means Citi and the Fed are the only two potential dealbreakers. Reed said on Sept. 1 the merger is "absolutely on track," and Citi has already cut 50 employees made redundant by the deal. While the Fed won't comment, the bet-

shares vs. Travelers shares. According to one institutional investor, when the Tellabs-Ciena started collapsing the week of Sept. 7, many arbs faced margin calls. Since arbs were short Travelers and long Citicorp, they sold their Citi, because in a down market they usually keep their short positions and sell their long positions. The gap has since narrowed. Says one institutional investor: "You have a lot of margin pressure on the arbs who have to liquidate positions. And the rumors picked up because it was taking a lot longer to get regulatory approval than people thought, including the management of the company."

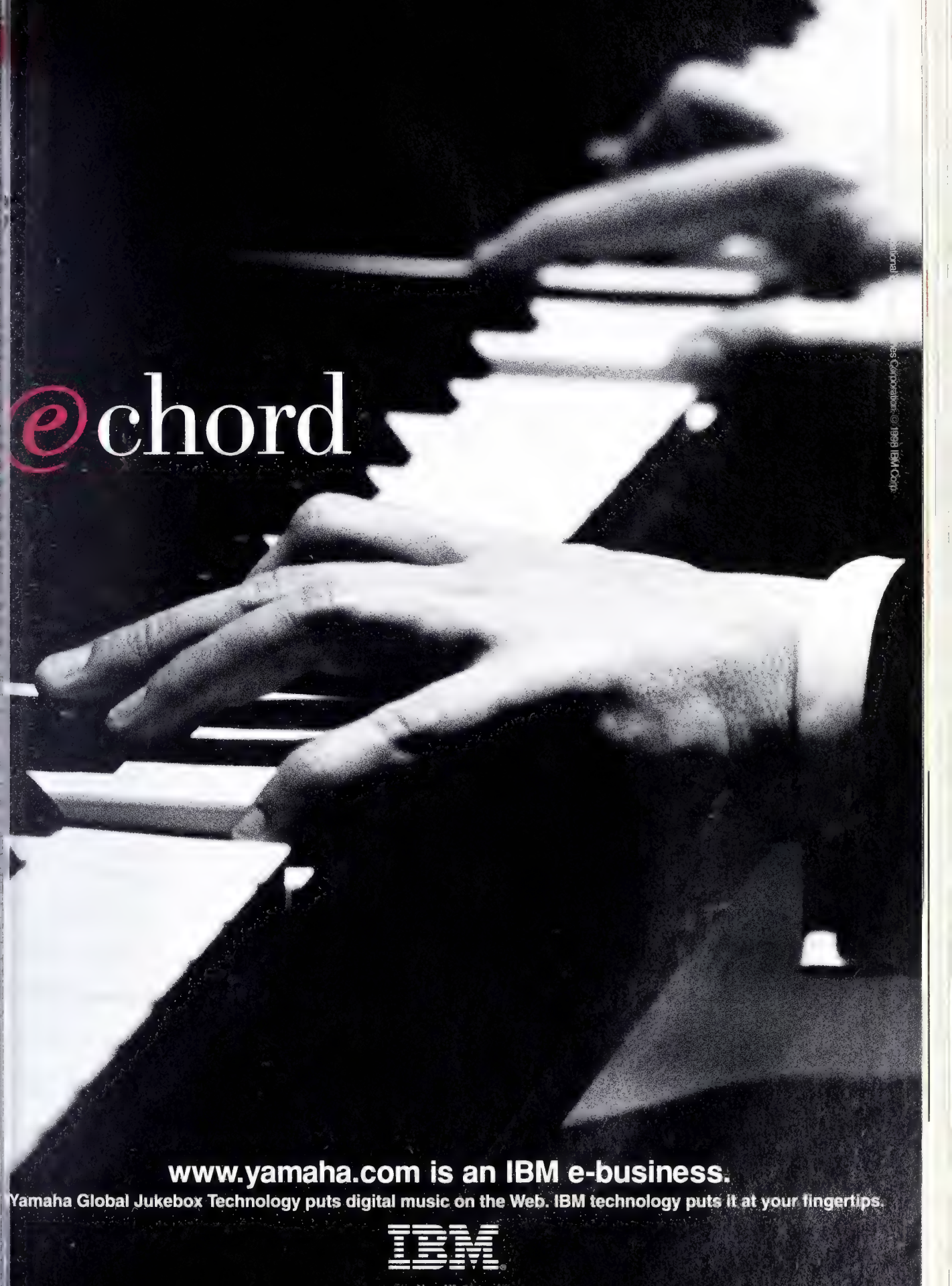
Longer range, the market reflects the turmoil in emerging markets. Of Citi's core business income last year, 56% was in emerging markets and 44% in the U.S. and other developed countries. "The golden attraction of Citicorp long-term was you have these huge masses of customers in the emerging markets, and the Citi brand is one of the few brands recognized around the world," says Howard F. Ward, portfolio manager of the Gabelli Growth Fund. But he has

Brazil tanks tomorrow."

Ironically, Weill's pain may be Reed's gain. For Citicorp, the deal could reduce its dependence on profits from the developing world. "To some degree, John Reed hedged his emerging-markets exposure by joining with Travelers," says Charles Peabody, an analyst with Mitchell Securities. "If the financial markets continue to penalize Sand Weill for this exposure via Citicorp, have to believe there will be a shareholder revolt questioning if this is the right thing to do." Adds Schmidt: "We knew then what we know now, the share exchange ratio might have been a little more favorable to Travelers."

Yet most analysts, investors, and bankers are convinced the deal is solid and that Citigroup still makes sense. Says Raphael Soifer, bank analyst at Brown Brothers Harriman: "I don't know why anyone in his right mind would assume this deal is not going to happen." Weill has given his word. And don't forget the chummy slumber party.

By Leah Nathans Spiro and Gar Silverman in New York, with Dea Foust in Washington



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REAL ESTATE

REITs IN THE ROUGH

They're short of cash for deals as investors eschew their stocks

For years, the smart money was with Richard E. Rainwater. Mesmerizing Wall Street with his plan to turn his huge portfolio of Texas office buildings into a growth company, the Fort Worth dealmaker raised more than \$2 billion between 1994 and 1997 to acquire properties. But since July, the real estate investment trust Rainwater controls, Crescent Real Estate Equities Inc., has canceled three deals, including a \$465 million portfolio of office towers from Prudential Insurance and the \$1.5 billion purchase of Station Casinos Inc.

These are not grand times for real estate investment trusts. Less than a year after Wall Street was throwing money at REITs, eager to take advantage of their exemption from corporate taxes, money is fast drying up for REIT operators such as Sam Zell, Barry Sternlicht, and Mortimer Zuckerman. Morgan Stanley's REIT index has fallen 24% since January—compared with a flat performance for the Standard & Poor's 500-stock index—helping to torpedo deals. "Explain this to me," complains Zuckerman, chairman of Boston Properties Inc., among the nation's largest office REITs. "We have the best results in our history over the last six months, and my stock is at 26," he says, 27% off its high.

What's wrong? After three years of buying undervalued assets, REITs have driven up acquisition prices to levels that started to worry their investors. In many



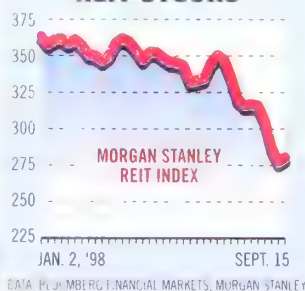
LOS ANGELES TOWER: Crescent backed out of the Prudential deal

suburban markets, the prices REITs were paying for office properties were as much as the cost of putting up new buildings. Initial rates of return REITs were getting on new acquisitions fell to 7% to 8% last spring from 10% to 11% two years earlier. And as REITs—and private entrepreneurs—began plowing money into constructing buildings, investors fled, fearing a real estate glut was fast approaching.

"It's the closest thing to yelling 'fire' in

a theater that I have ever seen," says Roy H. March, president of Eastdil Realty, a big property broker. The prices of REIT stocks are now trading an average of 10% below their breakup value, forcing many to contemplate huge stock buybacks instead of acquisitions. "No one can issue stock for deals," says Sam Zell, who did more than \$10

CRUMBLING REIT STOCKS



billion in deals last year and built the country's largest office REIT. A \$990 million merger between two hotel REITs, Equity Inns and RFS, fell apart in September. Many industry watchers predict several of the REITs could be bought off by private investors.

Instead of deals, the pressure is on REITs to squeeze profits out of the assets they currently own. After buying back Westin and RIT Sheraton in 1997, Barry Sternlicht must now prove he can run

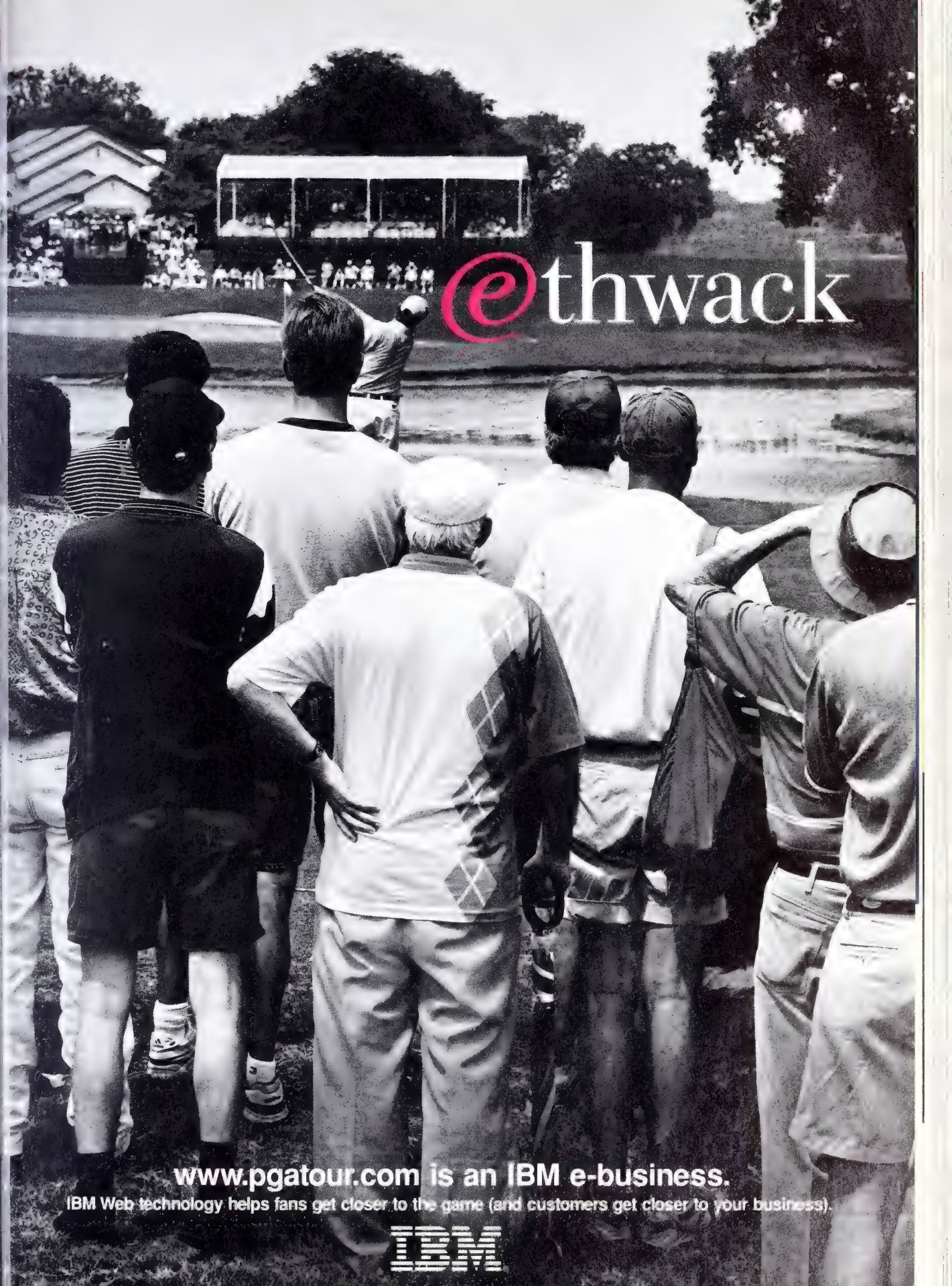
the world's biggest hotel company. With his tax advantaged paired REIT structure legislature away, Sternlicht has reformulated his company as a taxable entity and announced a \$1 billion buyback to boost its stock, now 50% below 1997 highs. "Now we are going to see who are the asset collectors and who are the real companies," says Cydney Donne, portfolio manager at European Investors Inc.

WAILING SIRENS. Ironically, most REITs are in strong financial shape. Rent increases are expected to boost average REIT cash flows by 16% in 1998 and 11% in 1999, says real estate research firm Green Street Advisors. And as deals go undone, asset prices have

already fallen at least 5%, says Green Street's Mike Kirby. With big issuers of commercial mortgages now sharply cutting back new lending, private developers will have a harder time getting financing as well. That should ease investor fears about a flood of new construction. "In past cycles, when there were few public companies, there was no siren wailing until we were swamped by oversupply," says Security Capital strategist Ken Statz. "The punch bowl has been taken away from this party way early."

How long the big REITs will be closed out of the buying game is unclear. Even now, many are negotiating with pension funds and private buyout funds about jointly financing deals. As the real estate market begins to cool, prices will again look attractive. But for Richard Rainwater, Sam Zell, and the REIT club, the days of easy money seem over—at least for now.

By Kathleen Morris in Los Angeles and Stephanie Anderson Forest in Dallas, with bureau reports



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BY GARY WEISS

WHY HEMISPHERX COULD TAKE SICK

At a time when many other biotech companies have seen their shares pummeled, Hemispherx BioPharma (HEB) has been a standout. The company's shares, traded on the American Stock Exchange, have risen 140% so far this year, as investors have laid bets that the company has an effective treatment for Chronic Fatigue Syndrome.

But in recent days, the shares have pulled back a bit.

IS ITS MEDICINE ABOUT TO FAIL?



DATA: BLOOMBERG FINANCIAL MARKETS

A number of short-sellers are betting that the company's potential has been vastly overstated by the market. At issue is a drug called Ampligen, which the company believes is effective against chronic fatigue. Among the short-sellers is Manuel Asensio, head of investment boutique Asensio & Co. Asensio is shorting the stock with a target price of zero, having taken the view that Ampligen is neither safe nor effective. Asensio calls Ampligen "a highly toxic, obsolete drug that is ineffective in the treatment of any disease." Hemispherx' CEO, Dr. William A. Carter, calls such assertions "frivolous and wrong" and says the drug's safety and effectiveness have been well established.

Other shorts note that the company was brought public by Stratton Oakmont, a notorious penny-stock house whose two former principals, Jordan Belfort and Daniel Porush, recently pleaded not guilty to federal money-laundering charges. Carter maintains, however, that Hemispherx was never tarnished by Stratton's numerous run-ins with regulators.

The shorts maintain that the company's shares are subject to substantial dilution from as-yet-unexercised warrants, options, and convertible preferred stock—most of them eventually exercisable at well below the current

stock price. Asensio calculates that, when exercised, they will boost the number of shares outstanding by more than 80%. A Hemispherx spokesperson confirmed Asensio's contention and conceded that the 23.6 million shares outstanding will swell to 41 million on a fully diluted basis. Carter, however, asserts that Hemispherx "doesn't believe there will be a substantial dilutive effect." But if the short-sellers are right, Hemispherx is setting itself up for a severe case of Shareholder Fatigue Syndrome.

ALPINE MAY BE SET FOR A CLIMB

Another target that is attracting short-sellers is Alpine Group (AGL), a holding company in New York. And the shorts seem to be on the mark: So far this year, the stock has dropped 16%, to 15 or so recently, as Alpine's Big Board-traded shares joined the market rout. But one value-hunting hedge-fund investor believes that the shorts are dead wrong. Rick Mastain, a general partner at Twenty-First Century Advisors in Park City, Utah, thinks the stock is way undervalued. He has been buying up shares, betting the price will double in a year or two.

As Mastain sees it, Alpine's breakup value is a good deal more than its current price. Its primary subsidiary is Superior TeleCom (SUT), another Big Board stock, in which Alpine has a 50.1% stake. Superior is a supplier of cables and copper wire to telephone companies. Mastain reckons that its stake in Superior alone is worth \$18 a share. The company also owns Premier Refractories International, which Mastain values at \$5 a share. Those two, plus

\$2 a share in cash, add up to \$25 a share. The company has seen its profits rise handsomely in recent months, with its net income climbing to \$6.2 million, or 36¢ a share, on \$289 million in sales in the quarter ended July 31, versus

\$4.4 million in profits, or 26¢ a share, a year ago. It has a price-earnings ratio of 11, based on estimated 1999 earnings. Not a glamorous business. But those numbers have a certain panache.

PENN NATIONAL MAY ROMP HOME

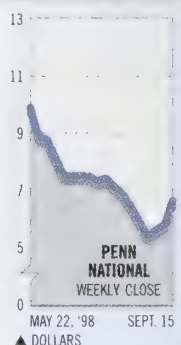
If the NASDAQ-traded stock of Penn National Gaming (PENN) were a race horse, it wouldn't be in the winner's circle—or even at the starting gate. It would be writhing on the ground with a severe case of colic. Penn owns and operates racetracks and off-track betting facilities: Charles Town Races in West Virginia, as well as Pocono Downs Harness Race-track and Penn National Race Course in Pennsylvania.

Gambling stocks, especially those of race-tracks, have been trampled by the market. Penn has been a dreary also-ran, with its shares falling 32% this year, to 6% recently, down from 20 a year ago. And its market capitalization has fallen to \$100 million—for a company whose quarterly earnings and revenues have been rising handsomely.

One small-cap investor, at least, thinks Penn National is a winner. Chuck Akre, who runs FBR Small-Cap Value Fund in Arlington, Va., feels that the market has been excessively cruel to Penn National. He notes that mutual-fund selling has depressed the share prices to the point that the stock is now a bargain.

Akre notes that earnings are healthy and that the company is flush with cash. Earnings before interest, taxes, depreciation, and amortization rose 42%, to \$7.2 million, in the quarter ended June 30, up from \$5 million in the like period a year ago. Akre believes that the stock will double in the year ahead.

LATELY, IT HAS PULLED UP LAME



DATA: BLOOMBERG FINANCIAL MARKETS

WAY DOWN IN THE VALLEY



DATA: BLOOMBERG FINANCIAL MARKETS

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POLYCOM

EDITED BY AMY DUNKIN

TIME TO SIZE UP SMALL CAPS?

If you think the Dow Jones industrial average has taken a bad hit recently, just take a look at the Russell 2000, the widely followed index of small-cap stocks. It has lost 28% since its high on Apr. 22 and is down 19% since Jan. 1. Compare that with losses for the blue-chip Dow—down 15% since its high on July 20 and up 0.46% since the beginning of the year.

As the stocks of many small-cap companies have crashed and burned, the sector has plunged into a bear market. But you won't hear those words on the lips of many small-cap mutual-fund managers. Instead, they see the recent sell-off—which has brought some favorite stocks down 50% from their highs—as a reason to celebrate. "I'm buying every day," says Ronald Baron, who runs the \$4.4 billion Baron Asset fund. "There has been no change in business fundamentals, only the stock price."

"WITH A VENGEANCE." Managers such as Baron believe that when third-quarter earnings come out at the end of September and investors see that the stocks of many companies with small capitalizations were beaten down unjustly, the sector could rally. Jim Awad, co-manager of the Heritage Small Cap Stock fund, is even more bullish: "We're going to shift into a small-cap rally with a vengeance." Why? A lot of people continue to buy big-cap blue chips every time they weaken, says Awad. But that buying sentiment is growing weaker, as shown by the dwindling height of each successive recovery. As a result, he maintains, "people

will look for a new way to make money."

Maybe Awad is overstating the recovery case a bit. Other small-cap pros are more cautious, as well they should be. Even the small-cap funds awarded three stars or better by Morningstar for their five-year returns have seen disastrous declines this year (table). But Robert Perkins, manager of Berger Small Cap Value fund, maintains that "when small caps come out of a correction, the reward is much greater" than for large caps. In anticipation of such a reward, Perkins has cut the amount of cash in the fund from 20% three months ago to 6% as he trolls for bargains. Among his recent buys: Brooks Automation, a manufacturer of semiconductor gear that is selling at 9, down from 41 last fall. Brooks is debt-free, and revenues are rising at 15% annually.

For many managers, the underperformance of the



small-cap sector is easily explained. Wall Street's bull market has been fueled largely by America's love affair with index funds, which are composed mostly of blue chips. Investors also typically shift into stocks with market capitalizations exceeding \$5 billion toward the end of an economic cycle. That's because large issues have

greater liquidity than small caps, a feature that offers a margin of safety if the economy falls into recession and the equity market retreats.

But small companies usually do much better once the economy emerges from a recession, notes Thomas Maguire, the manager of Safeco Growth No Load fund. Take 1990: Small caps performed dismally, as the Russell 2000 fell 22%, compared with a decline of 6.5% for the Standard & Poor's 500-stock index. Investors got a rebound in 1991, when small caps returned 44%, compared with 26% for the S&P.

Of course, with the economy still strong even in the face of global financial turmoil, it's debatable whether the U.S. economy is flirting with recession. But many small-cap prices already reflect that possibility. While few managers are willing to say small caps have hit bottom, most agree that current valuations are too attractive to pass up and will certainly pay off over time. "We're paying what we think is

How the Top Small-Cap Funds Have Retreated

FUND	RETURNS*		
	5-YR	YEAR TO DATE	SINCE APR. 22
SAFECO GROWTH NO LOAD	18.35%	-9.76	-27.04
SCHRODER U.S. SMALLER COS.	17.51	-16.23	-25.96
FASCIANO	16.37	-1.48	-14.76
BERGER SMALL CAP VALUE INSTL.	16.36	-12.79	-21.56
WACHOVIA SPECIAL VALUES A	15.74	-10.42	-20.91
HODGES	15.10	-8.06	-19.58
GALAXY SMALL CAP VALUE RET. A	14.94	-14.10	-22.56
BARON ASSET	14.60	-18.35	-25.89
HERITAGE SMALL CAP STK. A	14.23	-22.64	-30.38
ECLIPSE EQUITY	14.12	-8.53	-21.29

*Through Sept. 4

DATA: MORNINGSTAR INC.



ap, with full recognition
the stock may get
aper," says Peter Larson,
manager of Galaxy Small
Value fund. Larson is
ish on Callon Petroleum, a
oil-exploration compa-
that has had a string of
ent successes. The stock
elling at 2.5 times cash
, and Larson thinks it
d sell at a multiple of 5
in 6 to 12 months. Cal-
stock fell from 16 in De-
ber to a recent 8, when
son bought in.

ANDING UNIVERSE. Her-
e's Awad looks for com-
ies that he expects to
e consistent, above-aver-
earnings growth and that
an buy at a price-earn-
ratio one-third lower
that of the S&P 500, cur-
ly at 24. He has added
is holdings of Sun Health-
Group, an acute-care
ing-home operator that's
ing at a p-e of five times
year's expected earnings
1.90 per share. It's selling
%, off its high of 22¹⁵/₁₆.
d also likes Doral Finan-
a bank holding company
has a dominant share of

the mortgage market in
Puerto Rico. It's selling at a
p-e of 13, based on 1999 esti-
mated earnings of \$1.30 a
share. He bought at 12, off
its high of 20%.

Roger Glenski, co-manag-
er of Wachovia Special Val-
ues, looks for stocks selling
at deep discounts, especially
those of companies with op-
erational problems that he

which makes and sells col-
lectibles affiliated with the
booming NASCAR racing mar-
ket. He expects the compa-
ny to earn 90¢ a share this
year. He bought it for 9, off
from 13¹/₂ at the end of July.
He also likes A.O. Smith, a
manufacturer of motors for
such household appliances as
air conditioners, washers, and
dryers. It's a high-margin

cash position rose from 3%
at yearend 1997 to 20% by
June 30, in part because he
sold some shares and didn't
aggressively buy new stocks.
"I'm not trying to do any-
thing too bold," says Fasci-
ano, who looks for compa-
nies that can double their
sales and earnings within
three to five years. He re-
cently added to his position in
Chicago Title, the No. 1 title-
insurance company in the
U.S. It has strong earnings,
a low p-e, and is flourishing
as low mortgage interest
rates spur a boom in home
sales.

Even if the small-cap sec-
tor continues to slide, it's im-
portant to realize that be-
cause these stocks are so
illiquid, prices can fall too far
and then shoot up once the
market turns. That turn may
not be in sight yet, but
small-cap bulls are starting
to load up before any rally
begins. They think prices
have come down so much al-
ready that adding some
small-cap stocks or funds to
your portfolio now can't be a
bad idea. *Toddi Gutner*

INVESTING Many pros see the recent sell-off as a gift. 'I'm buying every day,' says one manager

expects to be fixed soon. In
this market, "good businesses
without problems have got-
ten punished, so my universe
has expanded," says Glenski.
He has whittled his 15% cash
position prior to the sell-off
down to 10% by purchasing
stocks he previously thought
were too expensive. Among
them are Racing Champions,

business that is doing well in
a strong housing market. He
snatched up shares at 20,
down from the high of 35¹/₂ in
mid-July.

The most cautious one of
the bunch is Michael Fasci-
ano, and it shows in his re-
turns. His Fasciano Fund
has had the smallest year-to-
date decline—just 1.48%. His

ORDERLY GROWTH, AND NO ULCERS



No one would be surprised if your blood pressure weren't swinging wildly as

your mutual funds bounce around in the current turbulent stock market. Fortunately you can do something about that. Maybe it's time to look at an investment strategy that aims at stability over big capital gains.

One way to achieve this goal is to assemble a portfolio of money market, high-income bond, and balanced mutual funds. While its performance won't knock your socks off, the portfolio—we'll call it Slow and Steady—still offers reasonable current income and retains some exposure to the equity market for the day when stocks return to favor. The four funds that make up the portfolio have also turned in steady returns, with low volatility, over the past three years (table).

SMART MONEY

Let's start by putting 20% of your Slow and Steady portfolio into the money market fund. It will act as the anchor for the income portion of your asset allocation. Since money funds' net asset values don't fluctuate, the principal value of this part of the portfolio will remain intact.

Even if the market falls, this fund will hold its value and provide solid income. My favorite is Vanguard Money Market Reserves Prime Fund because it is waiving expenses and is extremely well-managed. The fund has a current yield of 5.28%, one of the highest available.

For even greater income and a chance at appreciation if yields continue to fall, invest the next 20% of the portfolio in a high-income bond fund. I like Vanguard Fixed Income High Yield Corporate. It currently has a 12-month yield of 8.74%, and manager Earl McEvoy is steering clear of lower-quality junk debt,

arguing that their higher yields don't justify their credit risk. In the last three years, the fund has averaged a 9.25% total return. Its standard deviation, a measure of the volatility of the fund's returns, is a comfortably low 4.4% and is a quarter of that of the Standard & Poor's 500-stock index.

SPLIT DECISION. One of my favorite all-weather fund groups is balanced funds, and that's where the remaining 60% of your assets should go. Balanced funds split their holdings between stocks—typically 60% of total assets—and bonds—the remaining 40%. The bonds add stability,

while the equities provide a return. In down markets these funds hold up well, while in rising markets you still get equity exposure. Having 60% of your portfolio in these funds will orient you toward conservative growth.

My choices for balanced funds are Vanguard/Wellesley Income and Invesco Balanced. Vanguard/Wellesley focuses on high-quality bonds and big-cap equities paying high dividends and has a yield of more than 5%. Vanguard/Wellesley has also scored a tidy average to annual return of 13.72% the last three years. Its standard deviation is 7.6%.

Invesco Balanced, meanwhile, has had a total average annual return in the last three years of 15.3%, with a standard deviation of 10.3%. Managers Charles Mayer and Jerry Paul currently favor defensive consumer stocks including retailers. They are partial to electric utility debt. But they say they are not anxious to dive into year U.S. Treasuries until their yield climbs back to 6.25%, roughly a percentage point above where they are trading at now.

The combination of a money fund, high income bond fund, and two balanced funds produces a current average portfolio yield of just over 5%. This is about equal to the yield on the average taxable money market fund, about 3.5 times the yield on the S&P 500. The combination would have achieved an annualized total return of 11.6% over the last three years, with a standard deviation of about 6.4%.

way the stock market is right now, you should count on returns of that order continuing. If this portfolio gives you plenty of cushion against further Wall Street volatility. Chip Norton

Norton is Managing Editor of S&P Personal Wealth (personalwealth.com)

A Slow and Steady Portfolio

FUND	ASSET ALLOCATION	YIELD	TOTAL RETURN*		STANDARD DEVIATION**
			1998	3-YEAR	
VANGUARD MONEY MKT. PRIME	20%	5.28%	3.52%	5.42%	0.06%
VANGUARD CORP. HIGH YIELD	20	8.74	1.35	9.35	4.40
VANGUARD/WELLESLEY INCOME	30	5.17	2.75	13.72	7.58
INVESCO BALANCED	30	2.21	-0.78	15.27	10.87
TOTAL	100%	5.02%	1.57%	11.65%	6.43%

*Through Aug. 31 **Measures variability of returns

DATA: MORNINGSTAR, INC.



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DELTA IV TEAM
WANTED A STRATEGIC
INTERNET PARTNER,
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THE RIGHT STUFF.

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U S W E B

FUND LOSSES: YOU MAY STILL OWE UNCLE SAM

Mutual fund investors have had a rough few months. But if the market doesn't do a quick turnaround, they are really going to be miserable come December. Not only will their funds have gone south, they'll also get hit with heavy taxes on the capital gains the funds have paid shareholders. Notes Milwaukee-based financial planner Paula

gains taxes at the same time? When funds sell assets, they're required to pass any gains or losses to shareholders. And many funds, especially those whose investors are running for the exits, have had to cash in holdings over the past month to raise money for redemptions.

Say your fund bought 10,000 shares of XYZ Corp. in '96 for \$30 apiece. By the

distributed to fund shareholders, who then owe a 20% tax. Those who reinvest distributions rather than taking them in cash will owe tax on money they don't actually have.

This is the same tax trap investors fell into back in '87, the last time the market took a big hit. According to Morningstar, at least 50 funds lost money that year but paid out capital gains exceeding 14% of assets. Fidelity Select Brokerage & Investment Fund lost

almost 37% but had to pay out a 15% capital-gains distribution. To John Reken-thaler, director of research for Morningstar, 1998 is an eerie replay of '87. "When you have gains in the first half of the year and the market falls in the second—that's when you get killed," he says.

While it's too soon to tell how widespread the tax problem will be, it's not hard to

they've had to sell stocks they bought cheaply years ago.

What can you do? Before you invest, shun funds with high turnover rates—some aggressive managers mull over their entire portfolio in a year like this. You can find a fund's turnover rate in its annual report on Web sites such as www.businessweek.com and www.morningstar.com.

Be leery of managers who suddenly shift investment philosophies. In today's down market, that's a classic recipe for negative returns and big distributed gains. Also look to see whether a fund is holding a bundle of unrealized gains. That's tougher to find, but the fund's annual report will give you clues. Or call a fund and ask before you invest. It can be a tip-off that you may be hit with a distribution in December.

CASH OUT? Index funds are less likely to produce big hits, as are funds that are managed with an eye toward keeping distributions—and capital-gains tax liabilities—low. You can control the timing of gains by investing in Standard & Poor's Depository Receipts (SPDRs) or World Equity Benchmark Shares (WEBS). Sold on the American Stock Exchange, they mimic U.S. and global index funds but trade like stocks.

If you still expect to be hammered, you can always cash out before your fund makes their distributions in December. But many advisers are wary of swapping merely to save a few bucks in taxes. "Just because a fund manager has gains, that's no reason to fire him," says planner Joel Ticknor in Reston, Va. Besides, there is a silver lining to getting hit with gains now. If you take them in cash, you'll have some dough to slip into a money fund until the storm passes. And any distributions you get now will lower your capital bite once you do sell your shares. *Howard Gleckman*

TAXES

Avoiding Unpleasant Surprises

► **LOOK** for funds that aim to ease your tax burden. These include index funds, which distribute few capital gains, and managed funds with low turnover.

► **WATCH OUT** for funds that are sitting on hefty unrealized gains. Invest now and you'll have to pay taxes on any distributions generated when the fund sells its holdings.

► **STEER CLEAR** of funds entirely. Buy stocks, since you realize gains only when you choose to sell. Or try Standard & Poor's Depository Receipts (SPDRs). They look like index funds but trade like stocks on the Amex.

start of this year, XYZ had climbed to \$75. Then the market slumped, and your manager bailed out last week at \$50. That locked in a \$250,000 drop in the fund's '98 returns. But it also generated a \$200,000 capital gain. By yearend, that money must be

find the traps. Small-cap funds, especially those investing in tech stocks, were red-hot through the first quarter. But the past six months have been a nightmare, and the average small-cap fund is down 20% for the year (page 118). The same goes for funds investing in banks. And Latin America funds? As their prices have plunged and redemptions have mounted,



Hogan: "This is the first time many people are going to face losses and get distributed gains."

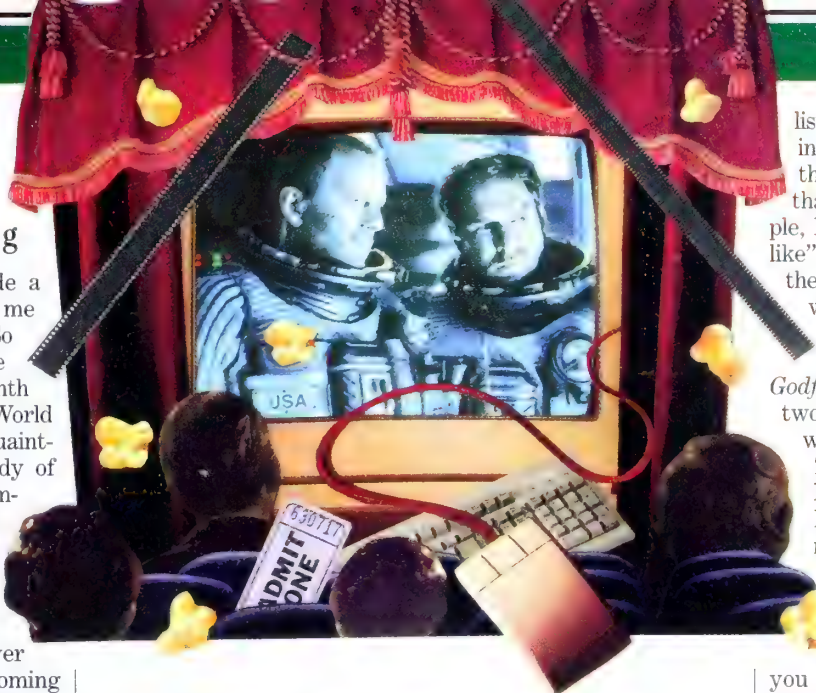
We're not talking about profits generated when you sell shares in a fund. Rather, these are gains earned by the fund when it trades stocks in its portfolio. How can you suffer a loss and owe capital-

Kira Kuro-
wa's classic
52 movie
out a dying

aucrat, *Ikiru*, made a
e impression on me
en I was in college. So
legendary Japanese
ctor's death this month
me right to the World
e Web to get reacquaint-
with Kurosawa's body of
k. I found plot sum-
ies of his movies,
norable dialogue (in
lish), and reviews.
yberspace is a cin-
maven's paradise
re you can pore over

enplays, peek at coming
actions, pick up gossip, and
irm whether the thumbs
iskel and Ebert are point-
orth or south. Along with
Siskel and Ebert Web site,
e are plenty of spots to
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ars will be best spent.
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Private Ryan earned a 98. To
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Airlines strike,
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films, including
the Waterfront
Matewan. At
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movie scenes,
ers, and other
such as a recent
view with Neal
ate, director of
dark comedy
Friends &
Neighbors.
nemanian's site
ures clips and
ers, as well as
mentary from



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bookseller Amazon.com. Up-

dated weekly, the collection
contains details on more than
150,000 films dating back to
the 19th century, and includes
2 million entries on luminaries
on either side of
the camera. You
can find listings of box office
grosses and Oscar winners.
You can do a search to see if
actors ever worked together. I
learned that Lucille Ball and
Desi Arnaz appeared together
on the big screen three times.

Despite all the content,
many movie sites suffer criti-
cal flaws. Consider moviefind-
er.com. It lets you search a

list of movies by genre, rat-
ing, and other criteria. But
the site may promise more
than it delivers. For exam-
ple, I went to the "films you'll
like" area, where you type in
the name of a movie, and up
will pop other titles with
something in common.

When I entered *The*
Godfather, however, the only
two names that popped up
were *The Godfather* and
The Godfather, Part 2.
Nothing turned up when
I typed in a more obscure
movie, the 1992 John Dahl
thriller *Red Rock West*.

The site also promises
lists of suggestions
based on the tastes
you display while grading
flicks. You must be a regis-
tered user to take advantage
of this feature. But to register,
you have to reveal your in-
come. I give that requirement
a thumbs down.

DEALING. Along with the re-
views and trivia, you can
play games that let you see
if you can figure out what
makes Tinseltown tick. The
Hollywood Stock Exchange
(www.hsx.com) is a stock mar-
ket simulation that starts par-
ticipants off with \$2 million in
play money to trade "se-
curities" representing films.
Shares are first offered dur-
ing the concept stage and liq-
uidated four weeks after na-
tionwide release. You can opt
in or out at any time. Three
months before the *Beavis and*
Butt-head movie was released,
it was priced at \$17. It traded
at \$22 on opening day, mean-
ing investors expected it to
garner \$22 million after four
weeks. The film actually
earned \$45 million and was
delisted at \$45. You can also
buy "StarBonds," based on
how well actors do at the box
office. The rules even allow
insider trading based on
firsthand knowledge of the
movie industry. Hooray for
Hollywood. *Edward C. Baig*

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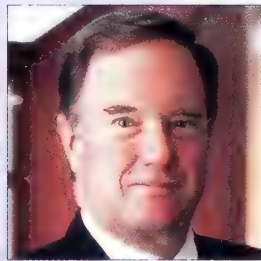
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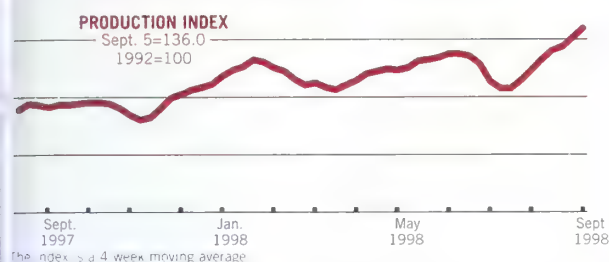
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PRODUCTION INDEX

Change from last week: 0.6%
Change from last year: 5.3%



The production index was up for the seventh week in a row. The unaveraged index increased, to 137.6, from 136.2 in the previous week. After seasonal adjustment, rail-freight traffic was up 3.2%, and the Association of American Railroads reported that cumulative figures for the first 35 weeks of 1998 show tonnage up 1.8% from a year ago. Output of steel, autos, trucks, coal, and lumber also up. Crude-oil refining dipped 0.8%, and electricity was unchanged.

For the week ending Sept. 1998, the M. Jones & Co. report.

TRADING INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STOCK PRICES (9/11) S&P 500	1009.06	973.89	9.2
CORPORATE BOND YIELD, Aaa (9/11)	6.42%	6.44%	-11.2
NEW SUPPLY, M2 (8/31) billions	\$4,252.0	\$4,237.2r	7.0
UNEMPLOYMENT (9/4) thous	312	304r	-0.3
MORTGAGE APPLICATIONS, PURCHASE (9/11)	302.5	305.1	41.2
MORTGAGE APPLICATIONS, REFINANCE (9/11)	2,141.9	1,924.0	329.7

Sources: Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Bankers Assn. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
FEDERAL FUNDS (9/15)	5.71%	5.66%	5.52%
COMMERCIAL PAPER (9/15) 3-month	5.33	5.43	5.51
CERTIFICATES OF DEPOSIT (9/16) 3-month	5.43	5.48	5.58
FIXED RATE MORTGAGE (9/11) 30-year	6.85	6.90	7.71
ADJUSTABLE MORTGAGE (9/11) one-year	5.65	5.69	5.79
LIBOR (9/16)	8.50	8.50	8.50

Sources: Federal Reserve, HSH Associates, Bloomberg Financial Markets

All data in the production indicators are seasonally adjusted in computing the BW index (chart); other components (estimated and not listed) include machinery and defense equipment. 1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

THE WEEK AHEAD

FEDERAL BUDGET

Friday, Sept. 22, 2 p.m. EDT ▶ The Treasury is expected to report that August outlays exceeded receipts by \$23 billion, based on the annual forecast of economists surveyed by Fitch IBCA and Poor's MMS, a unit of The Fitch IBCA Companies. That deficit would be less than the \$35.2 billion gap reported in August 1997. The budget for all of the 1998 fiscal year is on track to post a surplus in the neighborhood of \$70 billion, the largest in the modern era.

DURABLE GOODS ORDERS

Monday, Sept. 24, 10 a.m. EDT ▶ Orders taken by manufacturers of durable goods in August are projected to have held unchanged from their

July level, based on the S&P MMS survey. Orders in July had jumped 1.9% from June, when they rose a scant 0.1%, after plunging 3.3% in May. Looking through the recent volatility, new orders have weakened somewhat this year, led by metals and transportation equipment. Capital-goods orders, excluding aircraft, are holding up fairly well.

PERSONAL INCOME

Friday, Sept. 25, 8:30 a.m. EDT ▶ Personal income in August is expected to have risen by 0.5%, according to the S&P MMS survey, the same solid gain as in July. The rise reflects August gains in jobs, hours worked, and hourly earnings. Consumer spending on goods and services in August is projected to have increased

by 0.4%, a rebound from the 0.2% drop in July. That decline reflected the strike at General Motors Corp. and the end of attractive sales incentives, which had boosted June car purchases.

EXISTING HOME SALES

Friday, Sept. 25, 10 a.m. EDT ▶ Sales of existing single-family homes in August are projected to have dipped to an annual rate of 4.85 million, based on the S&P MMS survey. July sales had jumped to a record 4.93 million, from 4.74 million in June. Sales for the rest of the year will be buffeted by crosscurrents coming from weaker stock prices and lower mortgage rates. Already, lower rates have resulted in a surge in mortgage applications in early September.

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (9/12) thous. of net tons	2,074	2,112#	-4.6
AUTOS (9/12) units	88,534	127,043r#	-21.2
TRUCKS (9/12) units	89,477	130,930r#	-29.3
ELECTRIC POWER (9/12) millions of kilowatt-hrs	69,817	75,728#	2.3
CRUDE-OIL REFINING (9/12) thous. of bbl./day	15,420	15,352#	1.1
COAL (9/5) thous. of net tons	22,698#	22,258	14.9
LUMBER (9/5) millions of ft.	483.3#	494.4	22.8
RAIL FREIGHT (9/5) billions of ton-miles	27.8#	27.2	16.8

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WWP1, SFP2, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (9/16) \$/troy oz.	288.250	283.450	-10.0
STEEL SCRAP (9/15) #1 heavy, \$/ton	85.50	91.00	-37.8
COPPER (9/11) c/lb.	81.1	78.4	-17.8
ALUMINUM (9/11) c/lb.	66.8	66.5	-13.0
COTTON (9/12) strict low middling 1-1/16 in., c/lb.	71.62	72.43	1.2
OIL (9/15) \$/bbl	14.45	14.18	-25.6
CRB FOODSTUFFS (9/15) 1967=100	221.49	219.51	-7.9
CRB RAW INDUSTRIALS (9/15) 1967=100	280.11	285.19	-16.7

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (9/16)	135.05	137.30	120.85
GERMAN MARK (9/16)	1.69	1.73	1.77
BRITISH POUND (9/16)	1.68	1.66	1.60
FRENCH FRANC (9/16)	5.68	5.79	5.95
ITALIAN LIRA (9/16)	1673.2	1704.5	1729.8
CANADIAN DOLLAR (9/16)	1.50	1.52	1.39
MEXICAN PESO (9/16)	10.035	10.320	7.752
TRADE-WEIGHTED DOLLAR INDEX (9/16)	110.7	112.1	106.2

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan



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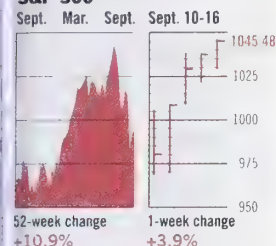
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Investment Figures of the Week

STOCKS

S&P 500



COMMENTARY

U.S. stocks bounced back partly from the lows of last week in the wake of news that the G-7 would move to spur world growth. Financial stocks led the charge. The battered Latin equity markets rebounded after President Clinton called for the developed countries to help emerging nations. On Tuesday alone the Brazilian Bovespa jumped 3.7%, while the Mexican Bolsa sprinted 12.9%. Interest rates declined, and the yield on jumbo six-month CDs dropped below 5% for the first time in nearly two years.

U.S. MARKETS

	Latest	% change Week	% change Year
Dow Jones Industrials	8089.8	2.9	2.6
NASDAQ Combined Composite	1689.9	4.0	1.4
S&P MidCap 400	311.8	4.2	-5.6
S&P SmallCap 600	152.1	2.7	-17.5
S&P SuperComposite 1500	220.0	3.9	8.0

SECTORS

	Latest	% change Week	% change Year
Bloomberg Information Age	352.3	4.7	18.7
S&P Financials	115.7	8.2	3.9
S&P Utilities	249.2	4.9	21.0
PSE Technology	321.2	3.9	-3.8

FOREIGN MARKETS

	Latest	% change Week	% change Year
London (FT-SE 100)	5291.7	-0.4	5.6
Frankfurt (DAX)	4858.0	-3.6	21.1
Tokyo (NIKKEI 225)	14,197.7	-3.8	-19.7
Hong Kong (Hang Seng)	7860.7	-0.6	-45.5
Toronto (TSE 300)	5906.1	0.6	-14.4
Mexico City (IPC)	3414.7	7.8	-31.8

FUNDAMENTALS

	Latest	Week ago	Year ago
S&P 500 Dividend Yield	1.52%	1.54%	1.60%
S&P 500 P/E Ratio (Last 12 mos.)	24.7	24.3	23.9
S&P 500 P/E Ratio (Next 12 mos.)*	19.9	19.5	18.9
First Call Earnings Revision*	-5.20%	-4.69%	-0.98%

TECHNICAL INDICATORS

	Latest	Week ago	Reading
S&P 500 200-day average	1062.0	1061.0	Negative
Stocks above 200-day average	18.0%	18.0%	Positive
Options: Put/call ratio	0.73	0.72	Positive
Insiders: Vickers Sell/buy ratio	0.80	0.98	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
HMOs	16.2	Broadcasting 67.3
Oil Exploration & Prod.	10.0	Drugs 52.1
Gold Mining	9.8	Drug Chains 50.2
Engineering & Constr.	8.6	Communications Equip. 46.4
Oil & Gas Drilling	8.2	Specialty Appar. Retailers 45.5

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Machine Tools	-24.5	Oil & Gas Drilling -54.7
Hotels & Motels	-22.8	Metals -48.5
Invest. Banking/Bkrgge.	-22.5	Leisure Time -45.9
Cosmetics	-20.2	Steel -41.6
Defense Electronics	-19.2	Machine Tools -37.6

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness

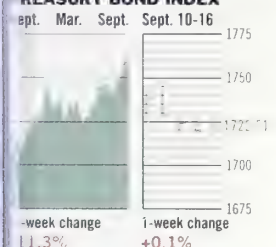
	Price	1-month change
Intel	85 15/16	-3 3/8
Citicorp	103 7/8	-39 7/8
America Online	97 1/2	-6 15/16
BankAmerica	62 13/16	-19 9/16
Telebras-ADR	72 1/8	-22 1/8
Merrill Lynch	59 1/16	-29 1/16

Decline ahead? Stocks with most significant selling on price strength

	Price	1-month change
Dell Computer	59 7/8	4 13/32
Microsoft	108 5/16	1
Northwest Airlines	30 13/16	13/16
American Home Products	55 7/8	3 7/8
Viacom-B	62 1/2	1 1/4
DuPont	59 1/16	4 1/8

INTEREST RATES

TREASURY BOND INDEX



Bloomberg Financial Markets

KEY RATES

	Latest week %	Week ago %	Year ago %
MONEY MARKET FUNDS	5.09	5.10	5.15
90-DAY TREASURY BILLS	4.72	4.88	5.10
6-MONTH BANK CDS	4.97	5.05	5.17
1-YEAR TREASURY BILLS	4.77	4.91	5.46
10-YEAR TREASURY NOTES	4.87	4.95	6.10
30-YEAR TREASURY BONDS	5.22	5.28	6.39
LONG-TERM AA INDUSTRIALS	6.21	6.27	6.90
LONG-TERM BBB INDUSTRIALS	6.91	6.80	7.27
LONG-TERM AA TELEPHONES	6.67	6.53	7.18

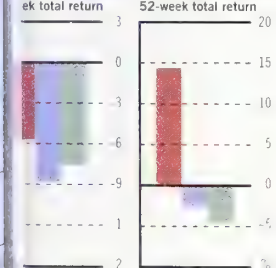
BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond Latest week	Last week	30-yr. bond Latest week	Last week
GENERAL OBLIGATIONS	4.22%	4.24%	4.88%	4.88%
PERCENT OF TREASURIES	86.64	86.05	93.41	92.67
TAXABLE EQUIVALENT	6.12	6.14	7.07	7.07
INSURED REVENUE BONDS	4.37	4.41	5.05	5.04
PERCENT OF TREASURIES	89.72	89.50	96.66	95.71
TAXABLE EQUIVALENT	6.33	6.39	7.32	7.30

MUTUAL FUNDS

S&P 500** U.S. Diversified All Equity



Morningstar, Inc.

EQUITY FUNDS

Leaders	4-week total return	%	Laggards	4-week total return	%
Guinness Mainland China	24.1		American Heritage	-33.3	
Prudent Bear	22.1		Montgomery Latin Amer. R	-33.3	
Newport Greater China A	13.0		Lexington Troika Russia	-30.8	
U.S. Global Inv. China Reg.	12.0		Vontobel Eastern Europ. Eq.	-30.4	
Lexington Strat. Invmnts.	10.6		Excelsior Latin America	-29.8	
Leaders	52-week total return	%	Laggards	52-week total return	%
Smith Barney Telecomm. Inc.	47.7		Lexington Troika Russia	-87.8	
Janus Twenty	36.0		Matthews Korea I	-67.5	
Flag Investors Commun. A	33.8		Guinness Fgt. Asia Sm. Cap	-67.5	
Fidelity Select Health Care	33.4		Lex. Crosby Sm. Cap Asia	-65.6	
Icon Telecomm. & Utilities	33.3		Montgomery Emerg. Asia R	-65.1	

EQUITY FUND CATEGORIES

Leaders	4-week total return	%	Laggards	4-week total return	%
Precious Metals	6.6		Latin America	-22.0	
Pacific/Asia ex-Japan	3.6		Small-cap Growth	-14.4	
Natural Resources	-0.7		Diversified Emerging Mkts.	-13.6	
Diversified Pacific/Asia	-1.2		Small-cap Blend	-13.3	
Japan	-1.8		Real Estate	-12.8	
Leaders	52-week total return	%	Laggards	52-week total return	%
Utilities	17.3		Pacific/Asia ex-Japan	-52.6	
Communications	14.9		Latin America	-48.4	
Europe	11.7		Diversified Emerging Mkts.	-46.4	
Large-cap Growth	11.0		Diversified Pacific/Asia	-40.7	
Large-cap Blend	7.9		Precious Metals	-36.0	

are as of market close Wednesday, Sept. 16, 1998, unless otherwise indicated. Industry include S&P 500 companies only. Fundamentals, technical indicators, Bloomberg mon-

ey flow analysis, and mutual fund returns are as of Sept. 15. For a more detailed explanation, write to us or E-mail figures@businessweek.com. r=revised **Vanguard Index 500 Fund

THE SHAME OF PRESIDENT CLINTON

It is no small thing to nullify a Presidential election and cancel the manifest will of the people. Yet the House of Representatives must now contemplate this drastic action, thanks to a reckless and mendacious Bill Clinton. Independent Counsel Kenneth W. Starr has opened a legitimate debate on whether the President should continue in office. And for good reason. It is now clear that Bill Clinton almost certainly perjured himself in front of a federal grand jury about a sordid sexual affair that took place inside the White House. He then lied about it to his Cabinet, to Congress, and to the American people for seven long months. It is now the Constitutional duty of the House to proceed with the impeachment process, to examine all the information available and to decide whether or not President Clinton's crime rises to the level of an impeachable offense.

The House should proceed with all due speed in making its decision. The global economy is in crisis, old antagonists are taking power in Russia, and the Middle East is quickly becoming a tinderbox once again. American leadership is critical in the world today. The temptation to prolong the impeachment process simply for partisan political gain must be restrained for the sake of the country.

The American people deserve better from their President. Faux contrition about egregious errors of judgment is not sufficient. Hairsplitting displays of linguistic acrobatics about the definition of sexual relations and semantic sophistry about when a lie is not perjury insult the basic intelligence of the nation. However the impeachment process concludes, the President owes the public true honesty about his shameful behavior, an expression of genuine remorse, and a request for forgiveness.

REVAMPING THE LAW

While the sins of President Clinton's personal behavior betray the moral code of most Americans, the transgressions of Starr's public investigation raise many troubling questions, too. In its pornographic detail, sanctimonious zealotry, and legal sophistry, the Starr Report betrays its partisan political nature. The process by which the President's sex life has been thrown into the public arena calls into question the entire mission of the independent counsel and the statute that supports it. What began as an investigation into a land deal in Arkansas, years before Clinton even became President, wound its way by way of a dismissed civil suit into a perjury charge over sex. When the independent-counsel statute comes up for renewal in 1999, it must be revamped. As it stands, the law gives special prosecutors a license to look into any private or public behavior of a government official over any period of time with unlimited funding. This is anathema to a democratic way of life.

Starr promises to deliver more information on Whitewater, Filegate, and Travelgate sometime in the future. But if this current report represents his best effort at presenting impeachable

evidence to the House, as most of Washington believes it to be, then, after spending \$40 million, Starr apparently found nothing impeachable in his core investigations. Unless he intends to file further charges soon, elementary fairness, it seems, should require him to state this fact. Starr's labeling of Clinton's legitimate legal defense as an "abuse of power"—an impeachable offense—also mocks the idea of fairness.

What should happen now? There are many serious arguments to be made for resignation. A President needs moral authority to lead and Clinton's standing in Congress is at an all-time low. Clinton's personal problems are diverting attention from important legislation—and from the growing international economic crisis.

But resignation would set a terrible precedent. Driving an unpopular President from elected office by means of a politically-tinged investigation would undermine the democratic process. It is a feature of a parliamentary system that should not be imported into the U.S. The only choice is to proceed with the impeachment process.

REACHING CENSURE

As the House proceeds, it may conclude that censure is the most viable option. It may reason that despite the graceful personal behavior and perjury about it, the standard of "high crimes and misdemeanors" against the state has not been reached. Certainly the public is opposed to the impeachment of Clinton. Polls consistently show that by a wide majority people are disgusted by his philandering and lying but still support the job he is doing as President. Even after reading the prurient details in the Starr Report, most people prefer censure to impeachment. Politicians who ignore this strong public view and try to use the impeachment process for their own gain may do so at the peril of their own political lives.

Considering the politically supercharged atmosphere in Washington, BUSINESS WEEK favors some strong punishment short of impeachment. To begin to get there, President Clinton must end the semantics. His lawyers do him great harm in both the House and in the larger public arena by insisting he didn't lie. Unfortunately, Starr has made a veiled threat of indictment even after the President's term ends, thus managing to turn Clinton's habit of prevarication into a legal necessity. If the House eventually concludes that censure is the solution, it must put an end to this threat. Clinton would then have to receive de facto immunity from both Congress and the special prosecutor to escape legal jeopardy. They will lie the deal for censure.

It is President Clinton's long history of philandering and lying that has finally overpowered his strong abilities in formulating policies for a globalized world and prevented him from reaching that place in history he so desperately desires. Now, the House must decide his fate. It should decide with dispatch, heeding the wishes of the American people along the way.

It goes about a country mile.
(City mileage may vary.)



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Corporate Earnings WHO CAN YOU TRUST?

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WHEN
ACCOUNTANTS
TURN A
BLIND EYE

WHEN
ANALYSTS HAVE
A CONFLICT OF
INTEREST



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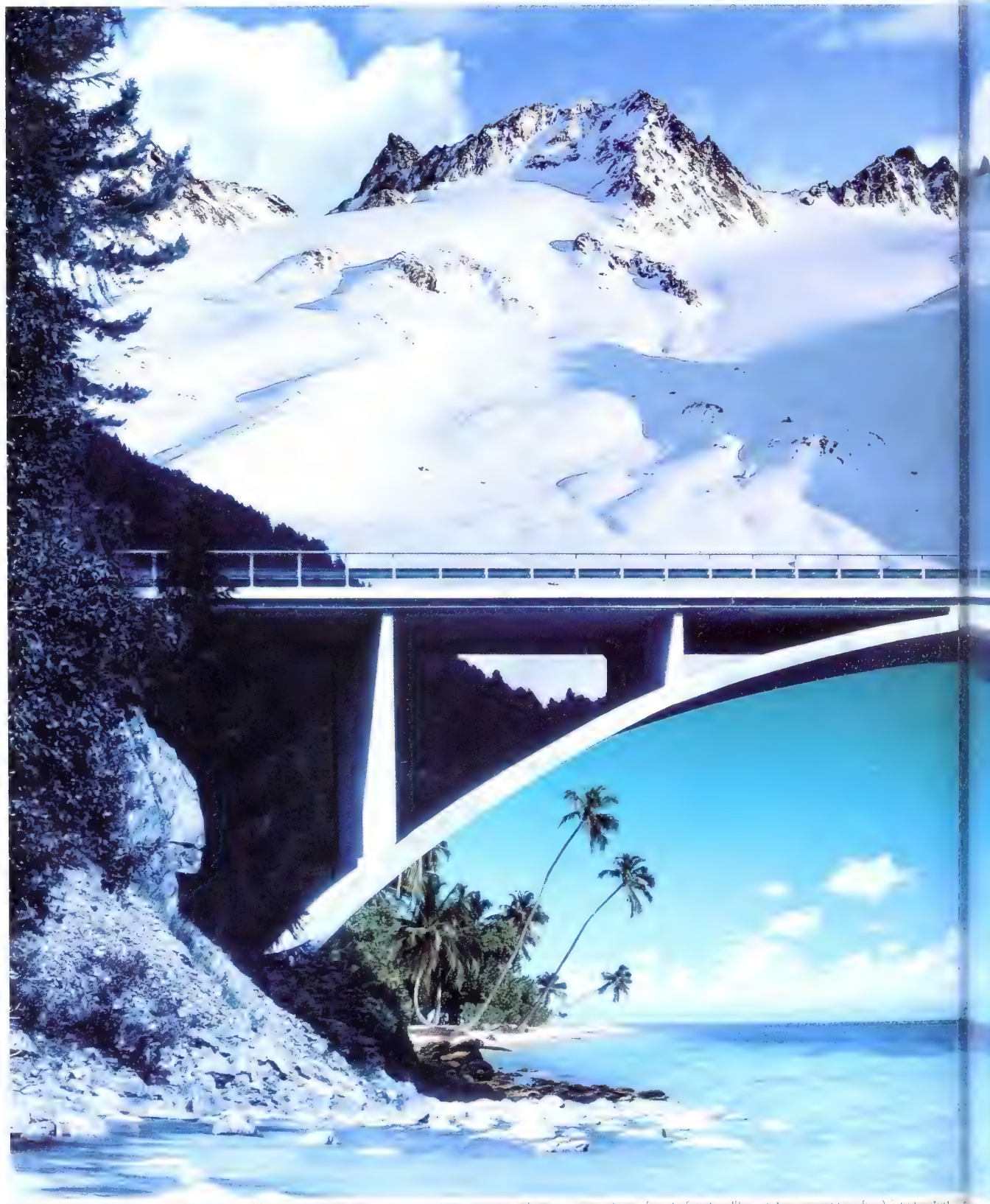
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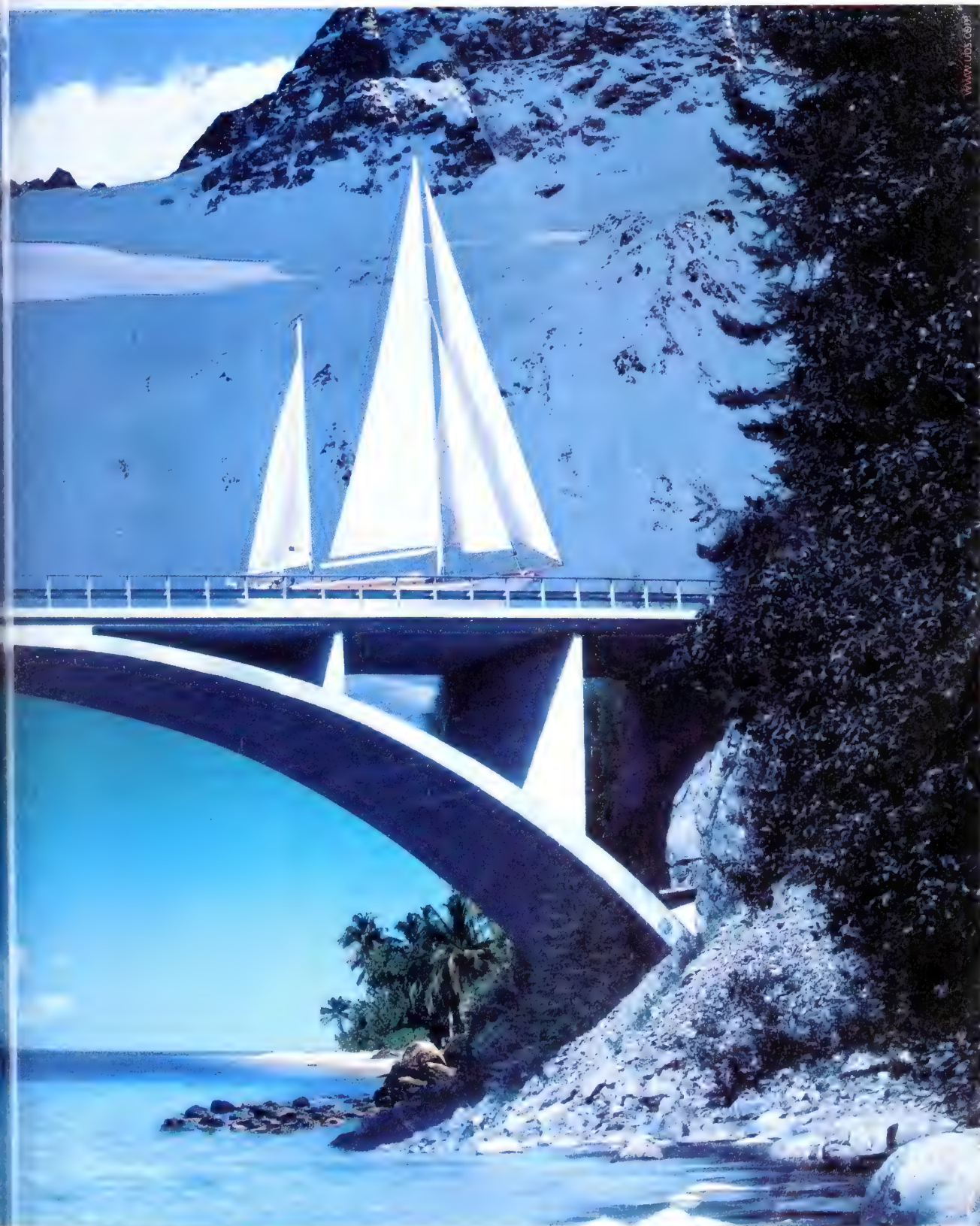
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When earnings statements push the limits, auditors are AWOL, and analysts are less than objective?

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At Liberty Media, Malone
will rule over
even more
TV fare
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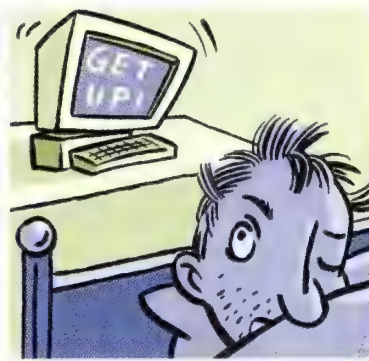
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Up Front

EDITED BY JOAN OLECK

STREET NEWS

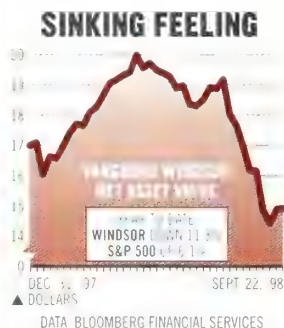
A FUND MANAGER SKATES ON THIN ICE

ABOUT THE LAST THING THAT mutual-fund directors are known for is dealing swiftly with laggard money managers. So the news that Vanguard Group's trustees were upset over the performance of portfolio manager Charles Freeman's \$20.7 billion Vanguard Windsor Fund came as a shock—even in the face of the fund's 11.3% decline this year through Sept. 22. (Windsor is distinct from Windsor II, up 1.8%.)

Come to learn, though, that 5 of Vanguard's 10 trustees have good reason to be concerned: Together, the group holds an unusually large stake in the venerable fund, more than 545,000 shares, according to Windsor's most recent proxy statement. Vanguard Senior Chairman John Bogle reported direct

holdings worth \$2.2 million at today's prices, while CEO John Brennan held even more: \$2.8 million. And Princeton's Burton Malkiel, author of *A Random Walk Down Wall Street*, was down for \$1.9 million.

Altogether, the trustees' Windsor stake began 1998



with a value of \$9.3 million. Now, it's closer to \$8.2 million—a \$1.1 million message to Freeman to get his act together. Vanguard, however, says it has no plans to dump Freeman anytime soon.

Robert Barker

THE LIST THEY'RE SENDING YOU WHERE?

Some 81% of companies here and abroad said in February that they expect to send an increasing number of people overseas through 2000. That means more folks confounded by foreign cultures and customs. What's key: preparation. The 10 countries presenting the greatest assignment challenges are:



COUNTRY/RANKING	1995 RANKING	EXPATRIATE TALES OF WOE
1. CHINA	2	At his welcome banquet, an exec was served duck tongue and pigeon head
2. BRAZIL	Not ranked	Cell phones are vital because home phones don't work
3. INDIA	6	The pervasiveness of poverty and street children can be overwhelming
4. INDONESIA	8	Landlords typically demand rent two to three years in advance
5. JAPAN	1	While medical care is excellent, doctors reveal little to their patients

Also challenging: 6. Russia, 7. Mexico, 8. Saudi Arabia, 9. South Korea, 10. France

TALK SHOW "I'd give anything in the world not to have to admit what I've had to admit today."

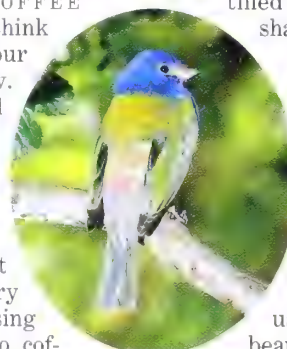
—President Clinton, in videotaped grand jury testimony

GREEN WATCH

THIS COFFEE IS FOR THE BIRDS

WAKE UP, COFFEE drinkers, and think birds with your morning brew. The National Audubon Society has dubbed October "shade-grown coffee month" to publicize the plight of 150 migratory bird species losing their habitats to coffee plantations.

Latin America's megafarms are clearing the shaded terrain where coffee traditionally has been grown—and chasing away 90% of the bird species. So how do caffeine addicts show support? The society suggests



PAINTED BUNTING

Café Audubon, a brew imported by EcoOrganic Coffee of San Diego. Under Smithsonian Institution guidelines, the \$11-a-pound brand is certified as organic and shade grown.

But it's a slow getting attention. "We are against the Starbucks of the world," says Audubon's Sarah Combs. (A Starbucks spokesman says it uses shade-grown beans but is not part of the Audubon program.) EcoOrganic expects more retail

access once it teams with distributor Boyd Coffee of Portland, Ore., in November. Early birds, human and avian, may tweet louder at the news.

Catherine Aron

CLASS NOTES

TWO B-SCHOOLS' PASSAGE TO INDIA

WHARTON SCHOOL AND Northwestern's J. L. Kellogg Graduate School of Management are normally fierce rivals. But the two B-schools are comfortable traveling buddies: Witness their working together for 14 years to develop the Sasin Graduate Institute of Business Administration in Bangkok. Now, the two parents have a second offspring: the Indian School of Business (ISB) in Hyderabad, due to open in 2000.

The school's godfather—Rajat Gupta, managing director of Me-

Kinsey & Co.—took the idea to 10 elite B-schools. Wharton and Kellogg, Gupta says, were the "best fit." And 20 U.S.-based teachers of Indian origin hope to teach at ISB. International donors will fund its \$100 million campus. Why India? First, there's the need evidenced by so many Indian MBAs. Second, "we're building a school not just for India but for the world," says Gupta.

HYDERABAD: MBAs coming



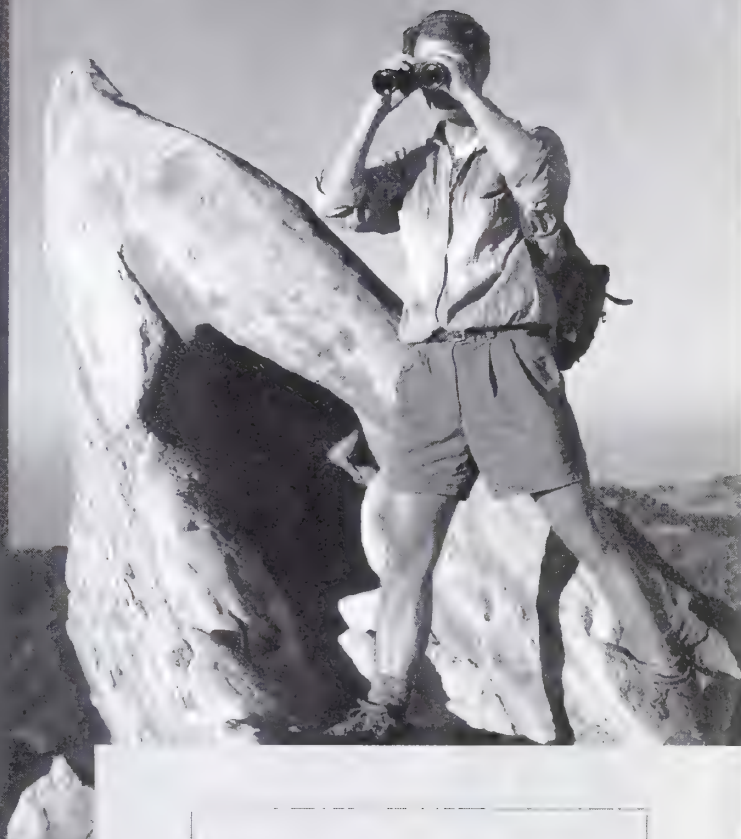
ta. And, from Kellogg Dean Donald Jacobs: India "has a large, rapidly growing economy, and it should have a world-class school." What about friction? "Yes, Kellogg and Wharton are competitive," says Jacobs. "That doesn't mean that we can't cooperate." Nadav Enbar

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ODDS AND ENDS

STOCKS IFFY? TRY 'DISNEYANA'

DOES MICKEY MOUSE EVOKE fond memories for you? How about the Seven Dwarfs? If so, you're the reason Walt Disney Co. is taking advantage of the craze for its mem-

phant" seat from a Magic Kingdom ride. A Mr. Toad seat fetched \$13,000; and a *Lady and the Tramp* booklet autographed by Walt Disney went for \$4,750. In all, the Disneyana convention at Walt Disney World collected \$312,000 from 60 auctioned items. Some 2,000 collectors and traders also paid \$1,200 to get in.

No one complained. "I consider it a legacy for my children," avid collector Kathleen Pickett of Garden City, N.Y., said of her \$6,500 painting of Disney's new Animal Kingdom theme park. Besides legacies, there are

investments: Some 1,650 porcelain figurines depicting the awakening kiss from *Snow White* and the *Seven Dwarfs* sold out at \$750 apiece. Buyers expected to double their money in a week. What was that about wishing upon a star? *Dennis Blank*

DREAM ITEM: Dumbo seat

orabilia—and drawing serious collectors in the bargain.

Consider: Last week in Orlando, businessman Douglas Dingee of New Canaan, Conn., paid \$22,000 for a "Dumbo the Flying Ele-

OVER THERE

LIFE'S A BEACH FOR EUROPEANS

ASIA MAY HAVE BEEN IN crisis and Russia in meltdown, but, hey, Western Europe had a great vacation. With their economies in recovery, Europeans this summer were again on holiday. European tour operators report

HOT SPOT:

The Caribbean

growth rates of 5% to 30%. "Our customers are smiling again," says Jacques Maillot, president of France's Nouvelles Frontières.

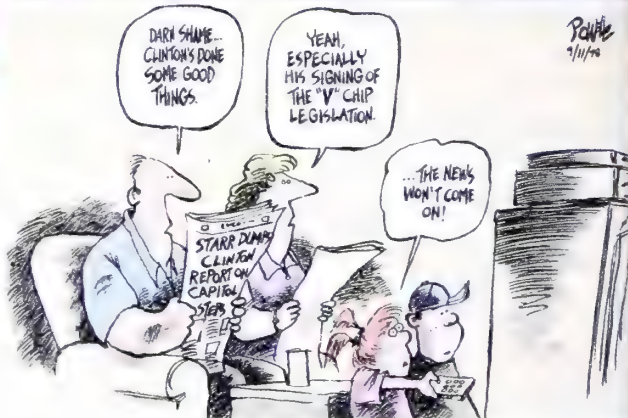
Maillot says the company lost \$20 million in 1997 but

this year should earn \$25 million. The breakdown of economic borders has helped. Britain's Airtours recently bought tour operators in Scandinavia and Belgium. And, says analyst Mark Brumby of ABN Amro in London: "We're seeing the creation of some big players who have leverage to increase their margins." A German merger, for example, created C&N Condor Neckermann Touristic, which did \$4.1 billion in sales last year. Also

helpful is increased travel to the Caribbean and Far East and more luxury bookings. One problem: Operators had counted on the Russians to fill economy-price rooms vacated by upscale Westerners. *William Echikson*



DRAWN & QUARTERED



SHOW BIZ

THE OLDEST TRICK IN THE BOOK?

THE MASKED MAGICIAN—Fox TV's star who likes to reveal the secrets behind popular magic acts—has been targeted by four lawsuits from angry fellow magicians. But is this just show biz? The Magician insists the hostility is real. In fact, he told *TV Guide* that death threats had forced him into hiding. "The magicians are out to get me," he said.

Old hands in the business suspect a PR trick as old as sawing a woman in half. "My guess is Fox wants [the Magician] to be sued to increase rerun value," says Penn Jillette of the Penn & Teller magic act. He would know: Penn & Teller long claimed

death threats from fellow magicians. But Jillette now confesses: "It was a complex lie." Fox had no comment. At least one lawsuit is



FOXY: TV's Masked Magician

hocus pocus. A Cincinnati part-time illusionist says there is a clear breach-of-contract issue, based on agreements magicians provide to the makers of magic apparatus. Maybe the Magician's lawyer needs something tricky up his sleeve. *Roy Furchtgott*

THE BIG PICTURE

UPSCALE COUCH POTATOES

NFL football is by far the TV sport of choice for Americans who earn \$100,000 or more. Budweiser is their favorite beer, and Ford their favorite car or light truck.



SPORTS PREFERRED BY THOSE WITH HOUSEHOLD INCOMES OF \$100,000 OR MORE

NATIONAL FOOTBALL LEAGUE

MAJOR LEAGUE BASEBALL

BASKETBALL

HOCKEY

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▶ PERCENT DATA: USDATA.COM

FOOTNOTES Business travelers who will pay extra for an empty adjoining airplane seat: under \$25, 16.7%; more than \$25, 14.3%



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MultiSync LCD1610™	1600x1200	1280x1024	22 lbs (10 kg)	YPS	YPS	YPS
MultiSync LCD1510™	1536x1024	1024x768	15.9 lbs (7.2 kg)	YPS	YPS	YPS
MultiSync LCD1410™	1400x1050	1024x768	14.5 lbs (6.6 kg)	YPS	YPS	YPS

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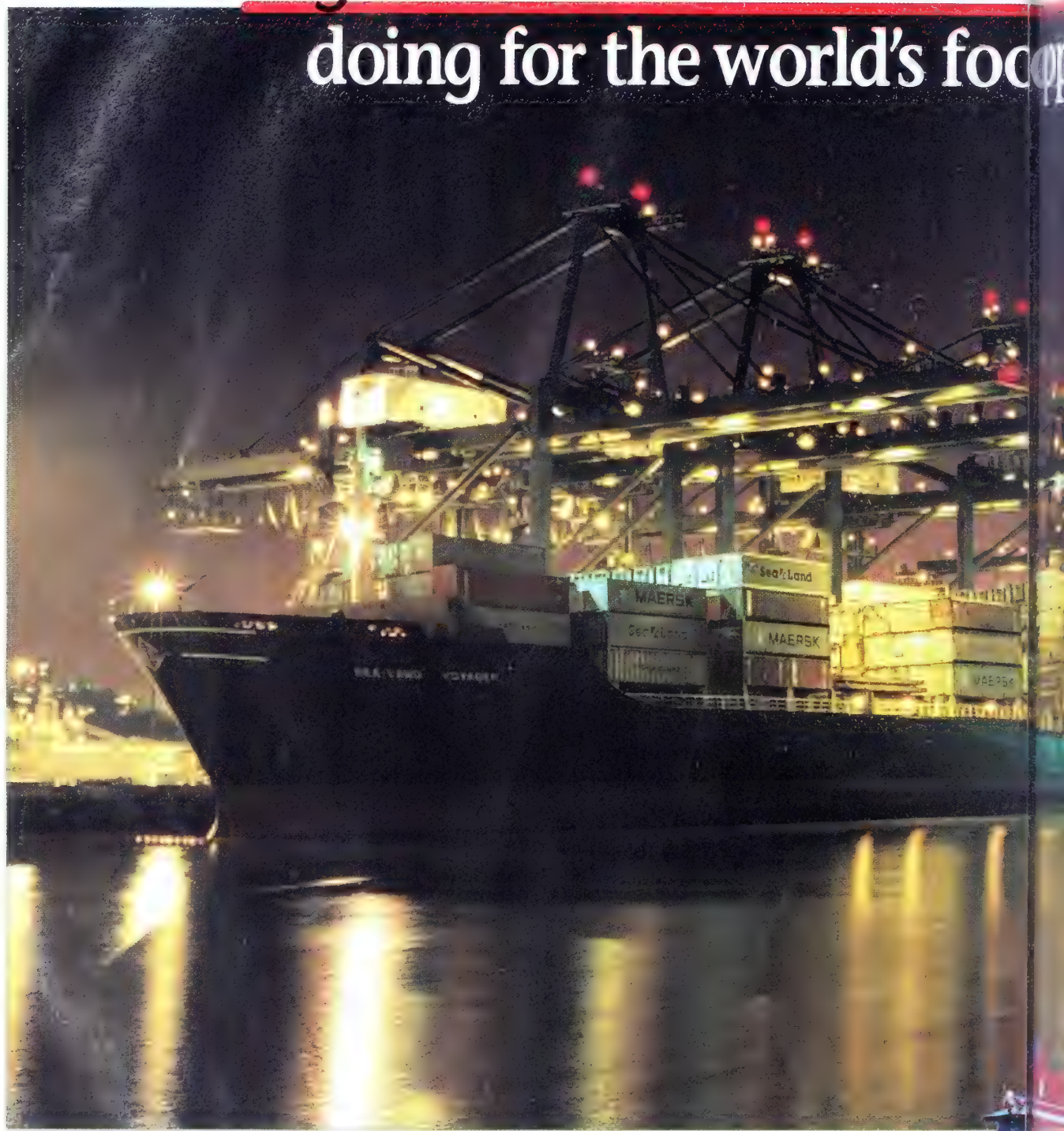
LCD2010 even boasts the largest viewing area of any LCD

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NEC
NEC Technologies

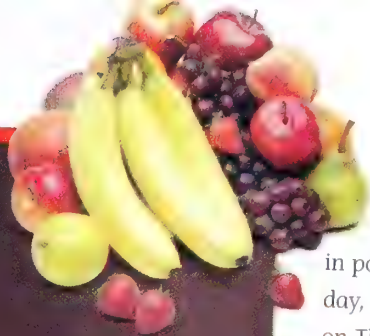
What's Ingersoll-Rand doing for the world's food



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control systems protect food
shipments worldwide.*



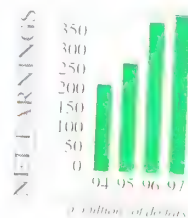
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A PLAGUE ON BOTH YOUR PARTIES

Your asking whether the GOP is "Still the party of big business?" (Government, Sept. 14) overlooks the notion that religion is as much a business as the rest of the "nonprofit" sector, which provides a huge market for labor and materials. My problem with the religious right is that it uses its clout to impose its views on others, including nonbelievers. For instance, some insist that terminally ill people suffer indescribable pain, rather than allowing individuals the right to seek assistance in ending their lives.

Mack A. Moore
Atlanta

Your article was a clarion call for a third party in the Year 2000 Presidential election without even hinting at the possibility. On economic issues, I consider myself a moderate conservative; on social issues, a moderate liberal. With both parties dominated by their extreme factions, I may not vote at all.

I have long been hoping for a moderate party dedicated to a pragmatic agenda and devoid of idealistic zealotry. If such a party could be formed, it would be a boon to broad-minded Americans. It would also be a good place for Corporate America to invest its political-action-committee money.

Martin I. Selling
Phoenix

THE CONSTITUTION ACCORDING TO GARY BAUER

Bauer claims to love his country, but he despises the federal government and its employees—unless, of course, they're forcing his will on the rest of us ("Rumble on the Right: A talk with Gary Bauer," *Government*, Sept. 14). He doesn't want "the Washington bureaucracy to get within 100 miles" of public schools when it comes to education standards, but he hopes to persuade the federal courts to allow prayer in the classroom. He says: "Washington will regulate a business to death," but he encourages

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[illegible]

it to regulate our sex lives. He supports human rights (instead of freer trade) with China, but his pinched view on women's reproductive freedom also wants to make global trade agreements conditional on abortion restrictions.

Bauer's agenda is self-serving hypocrisy. If the radical Religious Right wins its political battles, it will be the death of the Republican Party.

Rodney Hoffm
Los Angel

ONE WORLD—BUT IBM DOESN'T GET THE MESSAGE

So Chairman Louis V. Gerstner Jr. should reinvent IBM: an insightful story from a boardroom point of view ("For Blue should get a little smaller," *New Analysis & Commentary*, Sept. 14).

Let me provide an insight from the consumer point of view. To provide consistent, reliable, and global customer service, IBM should integrate its operations in North America and Asia. Those of us in Asia who operate North American-made IBM computers find ourselves lost in the "continental divide," with each division fobbing itself off on the other. Think global, IBM, think customer.

John Hanl
Tok

IS THE BREAST-CANCER THREAT OVERSTATED?

"Is your reproductive system in danger?" (Science & Technology, Sept. 1992) was misleading. Rates of breast cancer are stable, not "soaring." The increased incidence of this disease from 1980 to 1992 was due to improved detection methods. Screening mammography became widespread, and more low-grade tumors were detected; note that mortality rates were level during this same period and now show a slight decline.

The article also alludes to a report by John Brock, who found an association between high levels of polychlorinated biphenyls (PCBs) and non-Hodgkin's lymphoma in a small, retrospective study. There are many other studies that

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CORRECTIONS & CLARIFICATIONS

"Failed wizards of Wall Street" (Cover Story, Sept. 21) incorrectly labeled a chart. It showed the spread between five-year British gilts and swap rates—not, as indicated, the spread between the gilts and corporate bond yields. But in both cases, spreads widened dramatically.

and decreased incidence of cancer in workers who had been occupationally exposed to PCBs for decades. An Environmental Protection Agency is to spend millions of dollars in testing thousands of potential "endocrine disruptors," while children go without vaccinations, is another example of the state of our scarce public-health resources on pseudo-threats and scares.

Gilbert L. Ross
Medical Director
American Council
on Science & Health
New York

THE MYTH OF BUDGET SURPLUS

Henry Becker's story was titled "Don't look for tax cuts from this budget surplus" (Economic Viewpoint, Sept. 14), but there is no surplus! For decades, we have combined Social Security revenues with general revenues to obscure the size of our deficits. Now, we are perpetuating the delusion. Becker has an excellent opportunity to argue against increased expenditures by using accurate figures. The estimated budget for 1998, excluding Social Security, is a deficit of \$41 billion, according to the Budget Coalition. Now is the time to discuss the federal budget in real terms.

Allan Daily
San Jose, Calif.

WIRELESS STANDARD THAT MAKES SENSE FOR EVERYONE

Cell phones: Europe made the right choice (Science & Technology, Sept. 7) states that, in reference to proposals for third-generation wireless standards, officers at Qualcomm Inc. "say that Europeans have tweaked the technology in a way that will reduce Qualcomm's royalty streams from its patents." No officer of Qualcomm believes nor has made such a statement. Increasing the number of CDMA [code division multiple access] subscribers worldwide can only increase royalties. Qualcomm and other member companies of the CDMA Development Group have proposed a third-generation standard (CDMA2000) that is the natural evolution of current systems.

We believe that the European Telecommunications Standards Institute's proposed standard (W-CDMA) is crafted intentionally to minimize any compatibility with these current-generation systems. We do not believe nor did we indicate that W-CDMA would in any way reduce royalties payable to Qualcomm.

Qualcomm has stated that it would license its CDMA intellectual property rights on fair, reasonable, and nondiscriminatory terms only for standards

meeting the following three principles:

(1) A single, converged worldwide CDMA standard should be selected for the third generation.

(2) The converged CDMA standard must accommodate equally the two dominant network standards in use today (IS-41 and GSM-MAP).

(3) Disputes on specific technological points should be resolved by selecting the proposal that either is demonstrably superior in terms of performance, features, or cost, or, in the case of alterna-

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A close-up photograph of a woman with light brown hair, wearing a light blue button-down shirt. She is looking down at a dark, textured surface, likely a laptop screen, with a focused expression. The background is a soft, out-of-focus blue.

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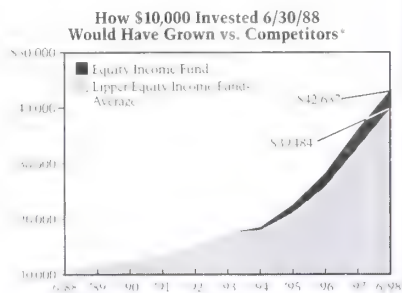
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Readers Report

tives with no demonstrable material difference, the choice that is most compatible with existing technology.

Qualcomm remains committed to a vision for the next century that will yield the best wireless communication in terms of performance and cost to millions of subscribers worldwide.

Irwin M. Jacobs
 Chairman and CEO
 Qualcomm Inc.
 San Diego, CA

ONE MAN'S TOY IS ANOTHER MAN'S HEADACHE

"Those #!*&#! jet skis roar up the Potomac" (News: Analysis & Commentary, Sept. 14) uses motorcycles as an incorrect comparison. Motorcycles are a useful means of transportation. They are registered, have license plates, and usually have insurance.

Jet skis, by comparison, are useless toys that have almost no practical function other than the consumption of gasoline. They are transported to water, they make a lot of noise, and are transported home again in other vehicles. I have always likened them to houseflies, which buzz around pointlessly all day, never actually going anywhere, never serving any real purpose, yet annoying a remarkable number of people who are minding their own business.

David Wineberg
 New York, NY

FRANCE'S SMART CARD IS A TEAM EFFORT

Oberthur Smart Cards has been selected by France's Health Care Dept. to be the main smart-card supplier of the first and largest health-care smart-card project in the world to date: Sesame-tale ("Medical care on a card," Social Issues, Sept. 14). The smart cards in this project are manufactured by three different vendors: Oberthur Smart Cards, with 40% of the project, in association with IBM for the integration technology part; Groupe Bull, also with 40% of the project, in association with Oberthur for manufacturing the cards; and Schlumberger, the remaining 20%.

Philip Tartavola
 Chief Operation Officer
 Oberthur Smart Cards USA Inc.
 Rancho Dominguez, CA

DID A TRADE CHART GET OVERSIMPLIFIED?

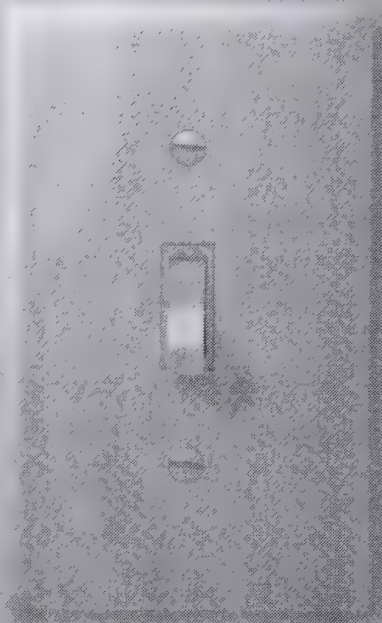
I was disconcerted by the chart presented with "Remedies for the gl-

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Readers Report

al crisis" (Editorials, Sept. 14). The chart, which is drawn in the form of a spider web, shows the contraction of trade that took place between January, 1929, and March, 1933. The only data points that are explicitly shown are the January figures, and they are not drawn to scale.

The chart suggests that there was a steady contraction of trade during this period. It is unlikely that the situation was so elegant. The simplification of the graph, while serving to illustrate your point, is deceptive and ultimately harmful to your position.

Mark Pixler
Taipei

Editors' note: The lines of the spider web chart were smoothed in error by the graphics department. But neither the shape nor the message it conveyed was significantly altered.

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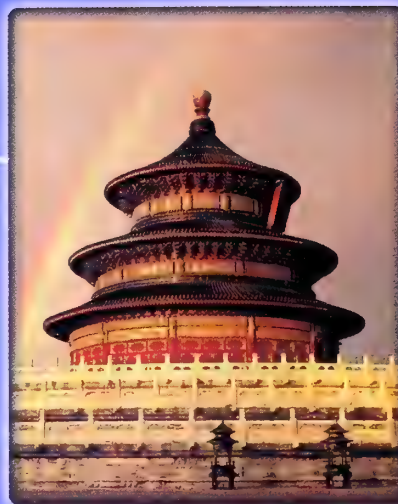
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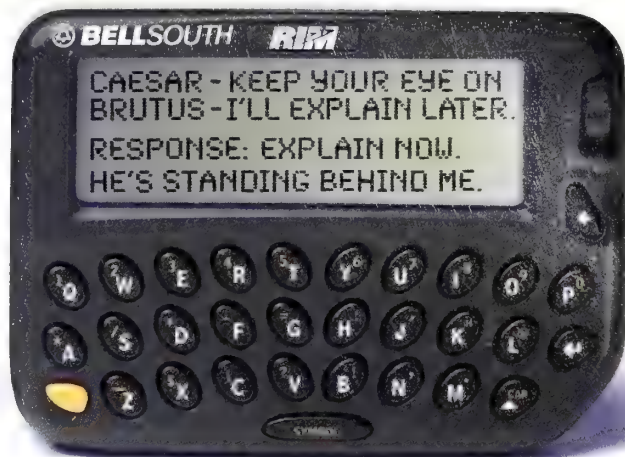
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Purchase tickets in advance or at the door

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By Reservation: \$15 Adults & Children
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Monday, November 30 10:00 AM - 2:30PM
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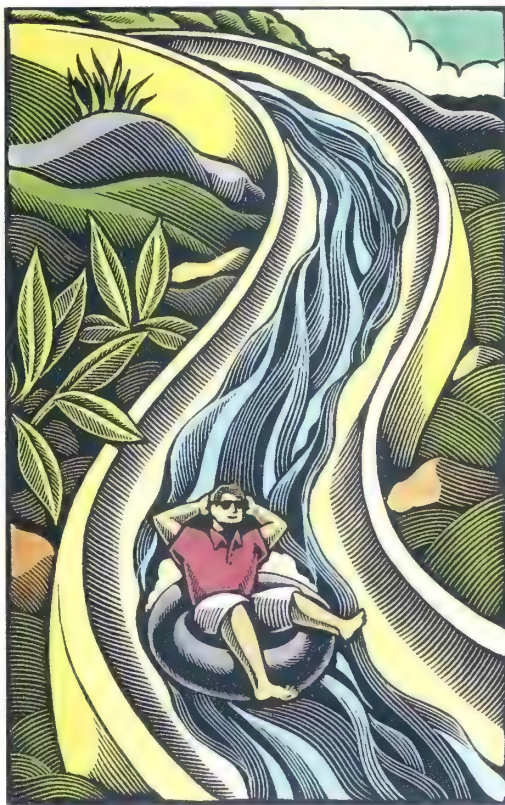
Life on Easy Street arrives with a surprise: the walk can be hard. The celebrated "comfortable" life, it turns out, often is not.

A friend suggested this when he reminisced about his earlier life: when you have no money, he said, you never worry about what to do with it.

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WORK IN PROGRESS

Michael Eisner with Tony Schwartz
Random House • 512pp • \$27.95

THE ENIGMA BEHIND DISNEY

New business books have as much going for them as *Work in Progress*. It's co-authored, after all, by Michael D. Eisner, the legendary CEO of Walt Disney Co. who notes that, in his 14 years at the helm, the company's market value climbed from \$2 billion to \$75 billion. Helping him craft his story was Tony Schwartz, a well-regarded magazine writer and co-author of Donald Trump's *The Art of The Deal*.

With such heavyweights, a reader might reasonably expect an important book, one that would reveal the essence of Disney's magic and offer real insight into Eisner's management style. Surely, one presumes, the pages will lay out some of the strategic thinking that has gone into building one of the world's most powerful media companies and will unveil Eisner's plans for navigating the 21st century ahead.

Unfortunately, *Work in Progress* is not that book. It's a smooth, interesting read—and it does offer some titillating details on Eisner's spats with Jeffrey Katzenberg, former head of Disney's movie studio, and with Michael Ovitz, the company's former president. But unless you're a Hollywood junkie willing to dig for nuggets, you'll find the story too familiar. And the inevitable one-sidedness of the account leaves the reader dismissing much of what is said as self-serving. Most disappointing is that the book provides little by way of new insight. At the end, one is left wondering: What is it about Michael Eisner that has made him such a successful manager? He remains as much of an enigma as ever.

Eisner says one of the reasons he wrote the book was because he and Frank Wells, the Disney president who died in a helicopter accident in 1994, wanted to share their views of "why we do what we do at Disney and what we stand for." Indeed, much of the book

reads as an homage to his former friend and colleague.

But perhaps because Wells is no longer around, the book ends up being more a chronology of Eisner's life. The early chapters describe his family, his courtship of his future wife, Jane (who clearly plays a role as a business adviser), his youthful days climbing the ladder at ABC, and the success he began to have on his own at Paramount Communications Inc.

Eisner also describes in vivid detail how close he came to having a heart attack—doctors say that without bypass surgery, he would have been dead in two days—and the impact that had on his life. In an excerpt from a letter he wrote to novelist Larry McMurtry, who also had a bypass, Eisner is at his most candid, confronting his mortality and describing his newfound lack of fear about death.

The problem is, passages like that are very much the exception. Eisner ultimately reveals little about his personal odyssey. His role as Disney's chief executive, for instance, reads more like a lengthy compendium. There's little insight into how he motivates and challenges people, wrestles with strategic dilemmas, allocates resources, or develops such a strong brand at a time when so many others are stumbling. When he attempts to impart management wisdom, it's disappointing: "To be effective, executives must be organized, keep their desks clean, answer their mail, return their calls, and remain sufficiently calm to put out each day's small fires before they spread." It's only then, he says, that he can do what matters most: "add value to the creative process."

To their credit, the writers don't duck all the tough questions. There's forthright acknowledgement of the financial problems that dogged the company with Euro Disney. The political missteps that occurred in pursuing the Disney's America project in rural Virginia also get ample treatment.

Perhaps not surprisingly, Eisner devotes considerable space to discussing his two nemeses, Katzenberg and Ovitz. Eisner paints the former as insensitive and unseemly; he says Katzenberg demanded Wells's job fewer than 36 hours after the latter's death. Katzenberg was more interested in his own ego and ascension than in the company's needs at that difficult time, Eisner says. He also says Katzenberg never really had a shot at the presidency, because he never earned the board's trust.

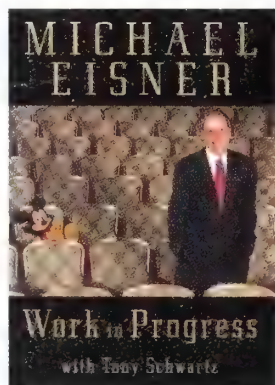
As for Ovitz, he clearly wasn't Eisner's first choice. In a search to replace the wisdom and seniority of Wells, he first dangled the presidency in front of then-Senator George J. Mitchell, who turned him down. After he hired Ovitz, Eisner discovered him to be ineffectual and, ultimately, disruptive. The end result: an unfortunate \$100 million-or-so severance package.

The book never offers a convincing explanation of why Eisner has trouble hiring and retaining top-flight managers. Nor does it take on the issue of his own lofty compensation, which has been the subject of considerable criticism. As for Disney's recent earnings disappointments, this book offers little guidance. In defending the weak showing of Disney's last few animated films, for instance, Eisner writes: "Our best hope is not to worry much about the competition and to focus instead on retaining our own commitment to excellence and innovation."

In the end, a reader comes away persuaded that Eisner has probably done something special to build Disney into a powerhouse company. But it will fall to another book to explain just what that something is.

BY SARAH BARTLETT

Bartlett is a *BUSINESS WEEK* assistant managing editor.



EISNER OFFERS LITTLE INSIGHT INTO

HOW HE KEEPS THE MAGIC KINGDOM ON TRACK

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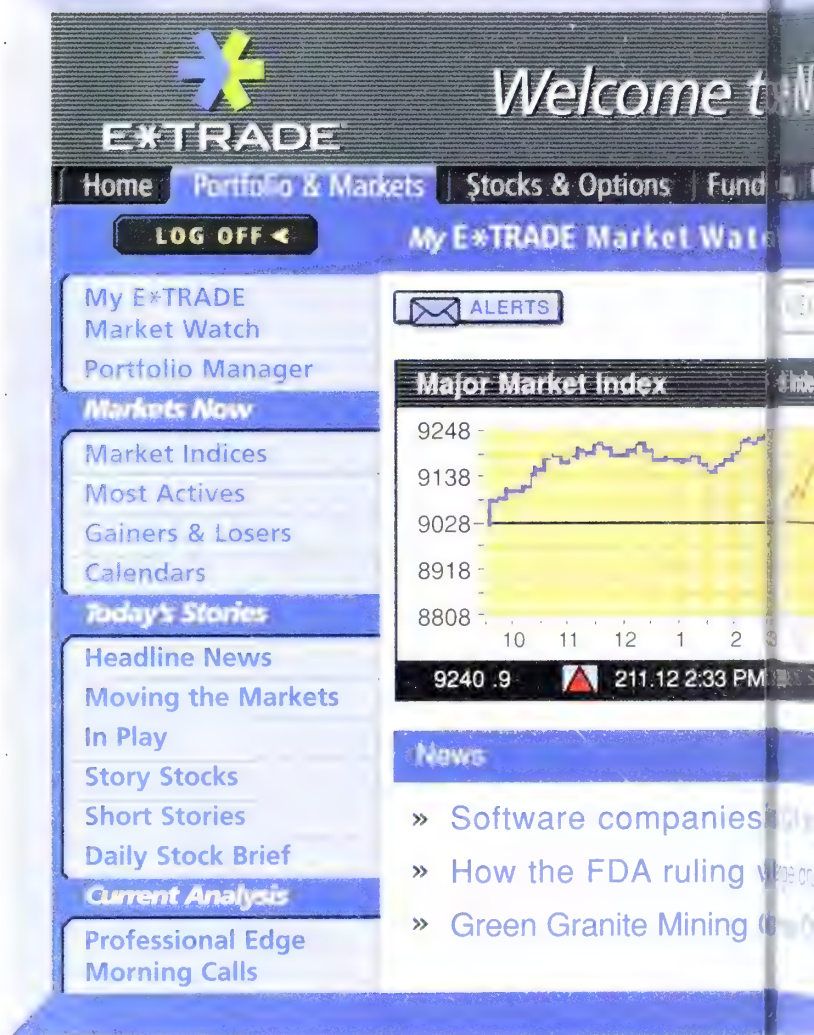
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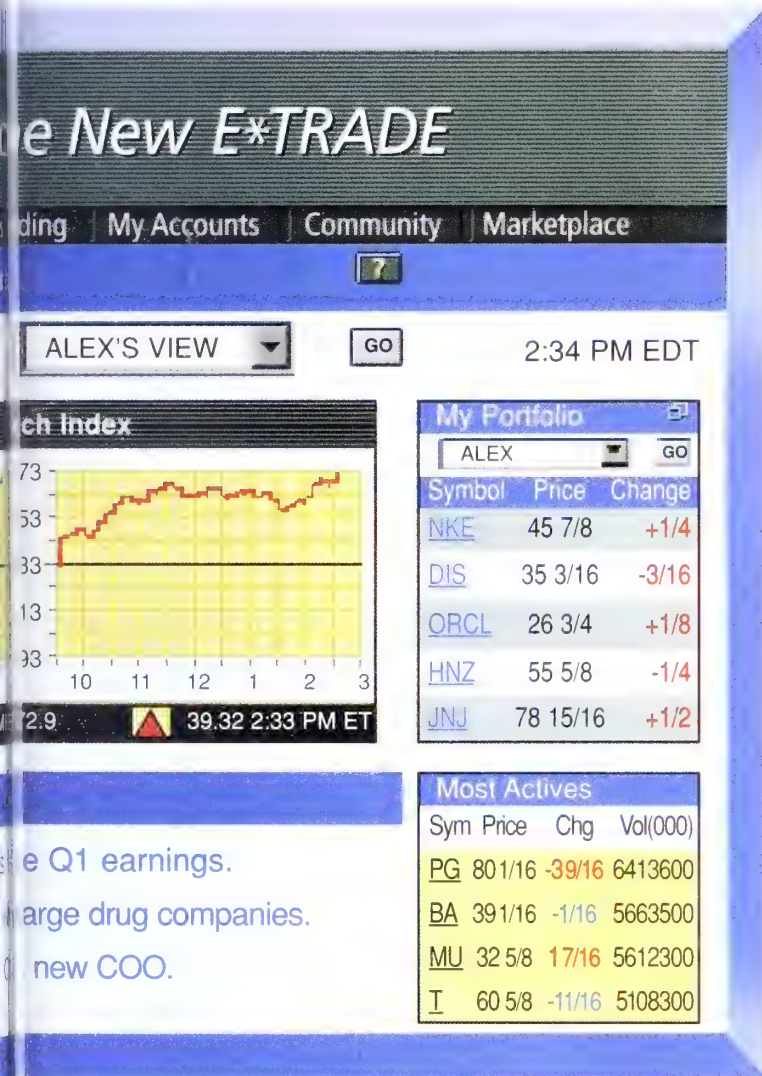
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- 4 **THE MOTLEY FOOL INVESTMENT GUIDE** by David and Tom Gardner (Fireside • \$12) *The online duo puts it on paper.*
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- 6 **THE 1998 WHAT COLOR IS YOUR PARACHUTE?** by Richard Nelson Bolles (Ten Speed Press • \$16.95) *The enduring job-search bible.*
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- 14 **HOME BUYING FOR DUMMIES** by Eric Tyson and Ray Brown (IDG Books • \$16.99) *Getting your dream house.*
- 15 **THE E MYTH REVISITED** by Michael E. Gerber (HarperBusiness • \$15) *Starting and maintaining a small business.*

BUSINESS WEEK's Best-Seller List is based on a survey of chain and independent booksellers that carry a broad selection of books on economics, management, sales and marketing, small business, investing, personal finance, and careers. Well over 1,000 retail outlets nationwide are represented. Current rankings are based on a weighted analysis of unit sales in August.

Reviews and more are available on AOL (Keyword: BW) or www.businessweek.com (Click on BW Plus!)

HOT TYPE

PAT RILEY HAD 11 OF THEM. RICK PITINO offered 10. And now, Lou Holtz, too, has 10 rules for success in his book *Winning Every Day*, the No. 2 hardback on this month's best-seller list.

Formulaic? You betcha. So skip over his rules and the homilies from sources such as Miles Davis and Justice Oliver Wendell Holmes. You'll get an afternoon's worth of football stories and come away feeling as pumped as if you had seen the home team pound the stuffing out of a despised rival.

Holtz is, of course, the enormously successful former football coach at the University of Arkansas, the University of Minnesota, and Notre Dame and is now a commentator at CBS Sports. *Winning Every Day* could have used better editing, but

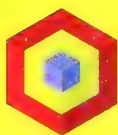
this shortcoming adds to the book's immediacy. "Baylor beat us every which way but loose," the coach recounts at one point in a mixed metaphor worthy of a first-team TV sports commentator. Later, he apparently bungles a quote from a lawyer, to wit: "I and 12 of your best players aren't going to play in the game..." Huh? Since when is there legal practice on the line of scrimmage?

But when adversity strikes, you know it won't be long before the relentlessly upbeat Holtz offers up a transcendent victory. "Catastrophes often disguise blessings," we read. Soon we get a electric account of Notre Dame's 1986, 38-37 comeback victory over Southern Cal. Awright, Irish—hammer 'em!

BY HARDY GREIL

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BUSINESS INTELLIGENCE

HAS IT CROSSED THE CHASM?

Over the past several years, an innovative business approach has gained an increasingly high profile. Business intelligence gives companies the ability to extract greater value from corporate information to enable everyone across the enterprise to make better decisions that directly impact the bottom line. Leading organizations worldwide are already achieving significant competitive advantage with business intelligence. But has it reached a critical mass? Is it moving beyond being the "invisible" advantage of Fortune 1000 companies to become an essential component of mainstream business success?

PASSING THE MAINSTREAM TEST

To answer these questions, consider what mainstream decision makers demand from a business approach. First, a record of proven, bottom-line results. Second, mature products and professional services to address the complete range of enterprise needs. Third, the security of dealing with an established market leader offering best-of-breed products and global support. And fourth, fast and easy deployment using an organization's existing IT infrastructure — often this is the single most important determinant of whether a technology achieves mainstream acceptance.

As the worldwide business intelligence market leader, Cognos Corporation of Burlington, Mass., is uniquely positioned to address all of these criteria. Through developing products that solve customers' specific business problems, Cognos has discovered effective ways to use business intelligence in every department of every enterprise, and in every industry. Today, organizations like Domino's Pizza, Ford, Johnson & Johnson and the National Association of Security Dealers (NASD) are cutting costs, increasing efficiency and enabling new strategic capabilities by adopting Cognos' award-winning business intelligence software. This market leadership is evident in Cognos' strategic

technology partnerships with other industry leaders such as IBM, Microsoft, PeopleSoft, Oracle and SAP. And Cognos business intelligence software deploys easily and quickly across the enterprise, typically delivering return on investment within 30 to 90 days.

SETTING THE AGENDA

The cornerstone of Cognos' success has been enduring customer relationships. As technologies and business needs have evolved, Cognos has responded with new products that extend business intelligence capabilities. Thanks to these pioneering efforts, a paradigm shift has occurred within many leading-edge companies: managers now expect to be able to

< Organizations like Domino's Pizza, Ford, Johnson & Johnson and the National Association of Security Dealers (NASD) are cutting costs, increasing efficiency and enabling new strategic capabilities by adopting Cognos' award-winning business intelligence software. >

easily access corporate data and view it from any angle, in any combination. They expect that creating reports will not be complex or time consuming. They expect to be able to automatically uncover hidden factors impacting their business. In other words, business intelligence has become integral to how they achieve and sustain competitive advantage.

THE POWER OF THE WEB

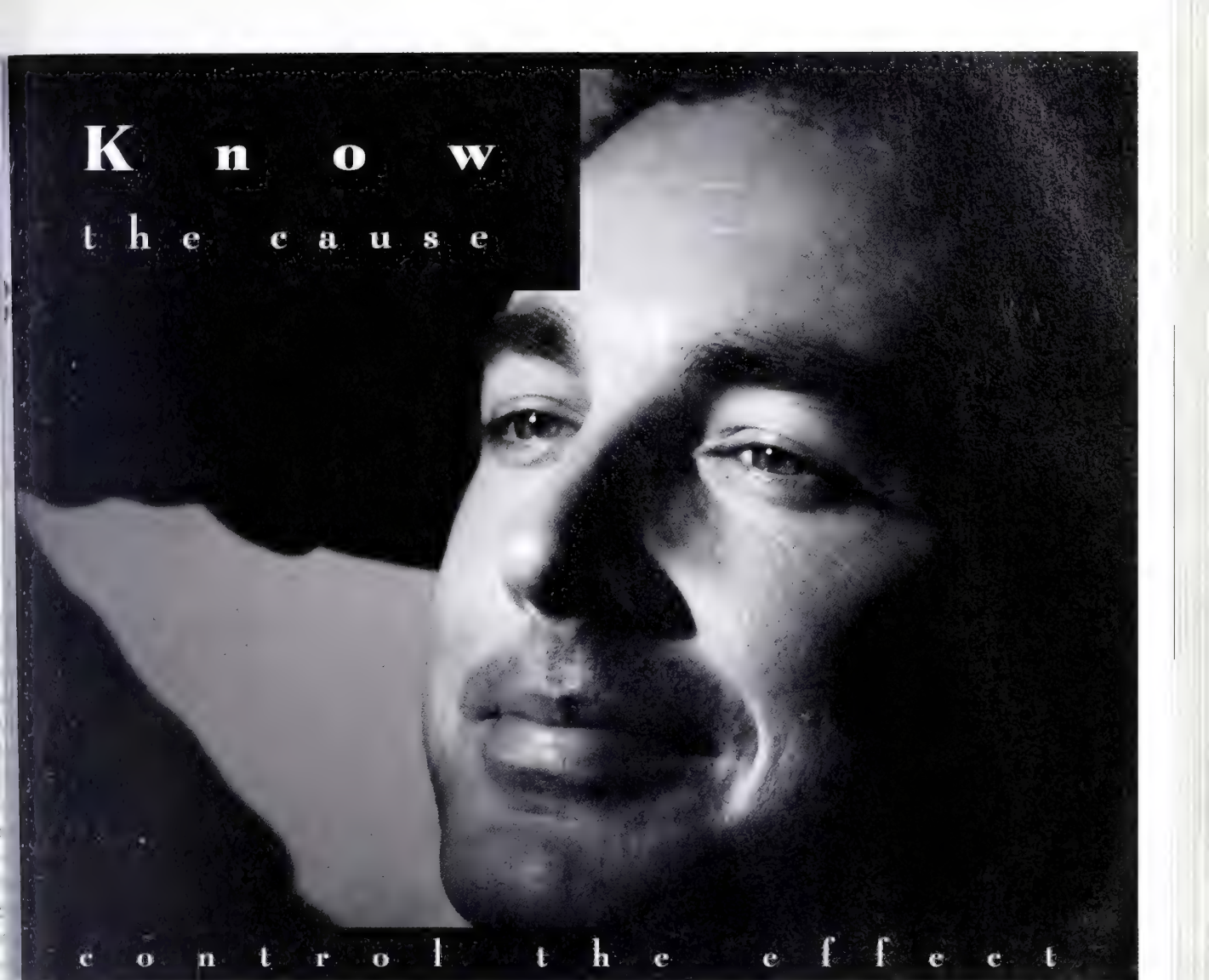
As business intelligence enters the mainstream, Cognos has developed products that leverage the World Wide Web, which has emerged as a mainstream computing platform. Through the Web, business intelligence capabilities can be distributed to an entire organization. As a result,

every department gains a broader perspective of their impact on the organization, and the impact of other departments on theirs. They can plan better and coordinate the flow of information across the organization. They can better align departmental goals with long-range corporate goals. The result

better decisions, every day — by everyone in the organization.



Learn how other companies have used business intelligence to cross the chasm to increased competitiveness. Order your **free** copy of *The Multidimensional Manager* book at www.cognos.com/chasm.



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BY STEPHEN H. WILDSTROM

A LAPTOP TO MAKE DESKTOPS QUAKE

Usually a follower, Dell breaks new ground with its big, brawny Inspiron

A couple of years ago, the idea of using laptop computers to replace the desktop computers of mobile workers began to catch on in corporations. When in the office, workers would slip their machines into docking stations, which link to big monitors, regular keyboards and mice, network connections, and other accessories. Because desktops remained cheaper and more powerful than laptops, the idea wasn't as widely implemented as advocates had hoped. Still, there are plenty of IBM ThinkPads and Compaq Armadas living in desktop docks.

Now, Dell Computer Corp. is attempting to recast the laptop-as-desktop along different lines. Dell's Inspiron 7000 D300LT, starting at \$2,999, features a massive 15.1-inch display that is only a hair smaller than the viewing area on a typical 17-inch monitor with TV-tube technology. Previously, 15-inch flat LCD screens have been available only as screens for desktop computers or in laptops from specialty vendors such as MetroBook.

With its display and a roomy keyboard that lacks only a separate number pad to be the equal of a desktop, the Inspiron can stand by itself on your desk. About the only add-ons you might want

are a standard mouse and the optional \$149 docking port, which simplifies connecting the Inspiron to the mouse, a printer, and other accessories.

The design goal is different from the older-style desktop-replacement laptops. Old-style laptops are intended for mobile workers, designed to move easily from office to briefcase to airplane to hotel.



The premium is on size, weight, and battery life. These laptops also include software and hardware that let corporate information-technology departments keep track of and update software. But individual buyers consider these expensive features to be of little or no value.

The Inspiron weighs in at 8.9 pounds and measures a bulky 2.5 inches thick, 12.9 inches wide, and 10.5 inches deep. (A version with a 14.1-inch display weighs 8 oz. less and is about half an inch

smaller in each dimension.) It will take a strong shoulder and a mighty big briefcase to tote this behemoth around. It could move between home and office without too much difficulty, especially if you don't ride public transportation. But you probably wouldn't want to carry it with your luggage very often. Don't even think about trying to use it on an airplane tray table, not even in first class.

Dell sees this as a desktop replacement primarily for home and small-business use. The company has found that about one of every five laptops it sells are intended for home use.

Dell is not the first computer maker to discover a distinct home market for laptops. Compaq Computer has enjoyed strong sales of its Presario laptop line. Unlike the Dell models, the Presarios

people who are prepared to sacrifice portability but who want a relatively powerful home computer with a big state-of-the-art display. What they get is a unit that will match most desktops in power and features but can fold up and almost disappear when not in use. Consumers may find it convenient to move the Inspiron from room to room, and if you go for the DVD option, a video-out connector will let you show movies on a standard TV set.

SIMPLICITY. Choosing a notebook over a desktop computer still carries a price. The 300 Mhz Pentium II—the fastest mobile processor available—is speedy enough for nearly all home-computing tasks, but it is slower than the desktop speed king, which clocks in at 450 Mhz. You can buy a 450 Mhz Dell

LAPTOP WITH A VIEW Dell Inspiron 7000 D300LT

SPEED	300 MHZ PENTIUM II
MEMORY	64 MB RAM, 4.0 GB HARD DRIVE
DISPLAY	15-INCH ACTIVE MATRIX DISPLAY
DRIVES	REMOVABLE COMBINATION FLOPPY/CD-ROM DRIVE
PRICE	\$2,999

DATA: DELL COMPUTER

are normal-sized machines boasting multimedia and convenience features. For example, the top-of-the-line Presario 1810 is a \$3,499 laptop that, like the Inspiron 7000, is built around a 300 Mhz Pentium II processor and 64 MB of memory. But it has a modest 13.3-inch display. Instead, Compaq puts its value into a DVD player (a \$200 option in the Dell) and what is probably the best sound system I've heard in a notebook. It also lets you play audio CDs even while the Presario is turned off and closed.

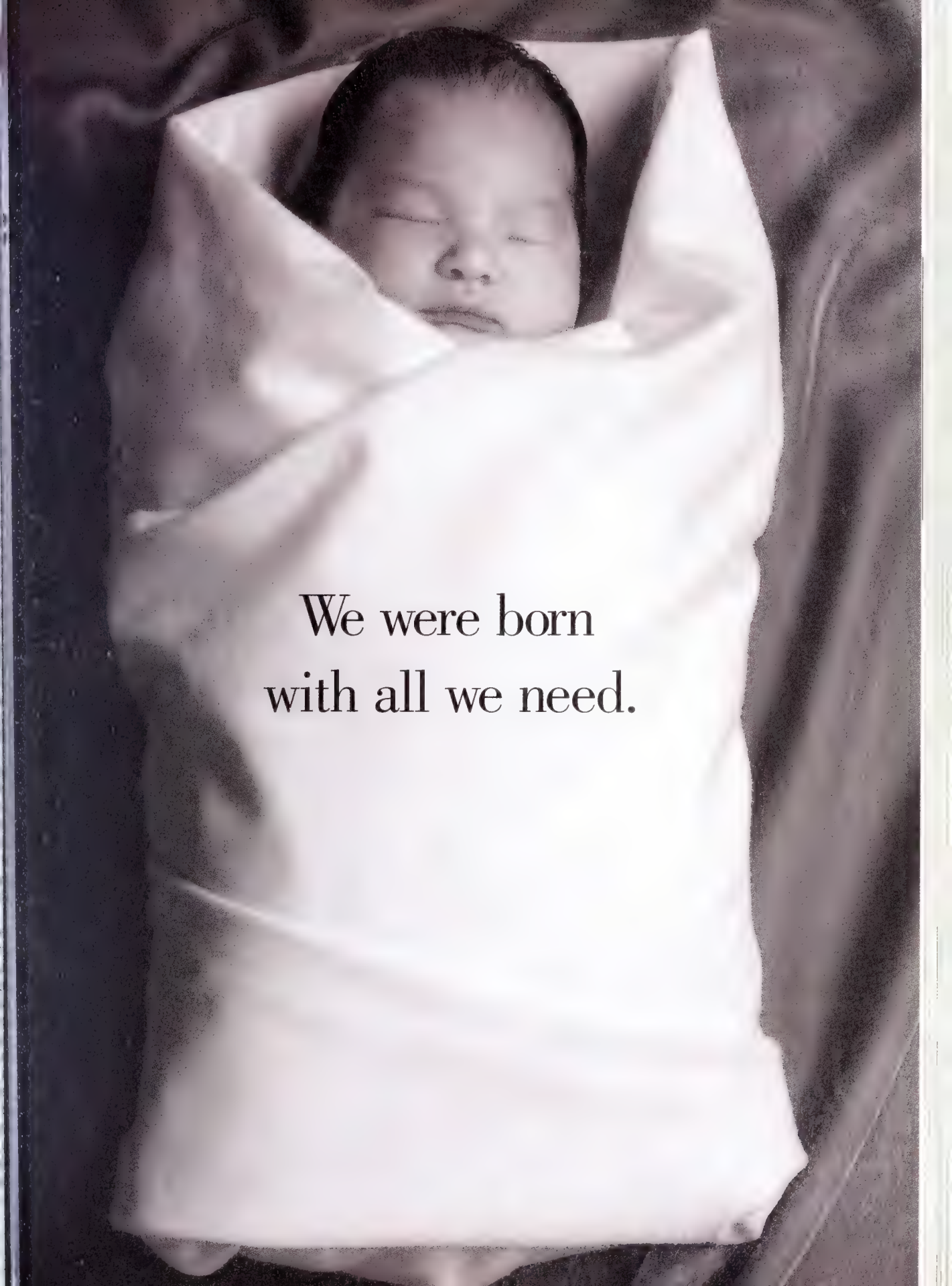
The main appeal of the Inspiron 7000 is likely to be to

Dimension XPS including a big 19-inch monitor, the same 64 MB of RAM, and a big 10 GB hard drive for \$500 less than the Inspiron. (For about \$2,100 you could get a Compaq Presario 5050 powered by a 333 Mhz Intel Celeron (a slightly slower version

of the Pentium II) with 64 MB of memory, an 8 GB hard drive, and a 14.1-inch digital flat-panel display.

Historically, Dell has been a follower in the industry, quickly emulating other manufacturers' successful designs. But by pioneering a product category with the Inspiron 7000, Dell has broken new ground. It is an experiment that other laptop makers are watching with great interest.

Will enough people find that the simplicity and small footprint of a laptop are worth the extra cost? Dell is betting that they will, and I suspect the company may be right.

A black and white photograph of a newborn baby wrapped in a white cloth, lying in a dark container. The baby's face is visible at the top, with eyes closed. The white cloth is folded over the baby's body, creating a protective cocoon. The background is dark and textured, possibly the interior of a car or a similar vehicle.

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BY GENE KORETZ

HOW SICK IS THE RUSSIAN BEAR?

Echoes of America's Depression

Many experts believe that the cause of the recent collapse of the Russian economy was the convulsion in currency markets that began in Asia and spread rapidly to developing nations around the globe. In this view, Russia was undergoing an acutely painful but necessary transition to a democratic, free-market system—a transition that was about to yield positive results but

TELLING SYMPTOMS OF A SOCIOECONOMIC DISASTER RUSSIA 1991-1997



was cruelly short-circuited by the aftereffects of the Asian crisis.

Not so, claims political economist Stephen D. Shenfield of Brown University. In a book he's writing on Russia's future—in a chapter completed before the Russian meltdown and circulated on the Net earlier this year—Shenfield predicted that the economy was headed for collapse. "It happened a bit earlier than I thought," he admits, "but I believe it was inevitable."

The basis for Shenfield's prediction: a wide range of statistical evidence that demonstrates that Russia's social and economic structure has been deteriorating sharply since the end of the cold war.

Using private as well as government statistics that give weight to Russia's large informal economy, Shenfield estimates that Russian gross domestic product fell about 45% from 1989 to 1997. Real capital investment plunged by 92% over the same period, and net productive investment has turned negative as aging equipment has become unusable.

Output of oil, for example—a major export—is down 50% from its peak and continues to fall in the absence of needed investment, and much of the nation's infrastructure—from electric-power gen-

eration to railroads to sewage systems—continues to deteriorate. Meanwhile, some two-thirds of the federal budget in mid-1998 was devoted to debt-servicing, Shenfield reports.

In human terms, too, the toll is growing. Shenfield notes that real wages fell 78% from 1991 to 1997, and surveys indicate that two-thirds of those nominally employed are not being paid fully or on time. Based on polls and official statistics, he estimates that at least 40% of the population is in serious distress and suffers from chronic malnutrition. According to one official estimate, 40% of children are chronically ill and 60% suffer from vitamin deficiencies.

The picture painted by demographic and health statistics is especially stark. The number of officially recorded active tuberculosis cases is now close to 100,000. (Some 2 million are believed to be infected.) Recorded cases of syphilis have exploded, from 8,000 in 1990 to 450,000 in 1997. Meanwhile, life expectancy for adult men has fallen below what it was a century ago, and the number of children born each year has plunged 50% since the mid-1980s.

What all of this portends, says Shenfield, is a huge socioeconomic disaster comparable in magnitude to the calamities suffered by the Russian people during World War II and the Stalinist period of forced industrialization and collectivization. In this context, he says, Western focus on such economic measures as debt repayment, monetary restraint, and eliminating housing subsidies could prove counterproductive—at least over the near term.

"In many respects," he says, "Russia's crisis in human terms resembles that experienced by the American people during the Great Depression, and it is likely to give rise to a similar period of state-led economic experimentation to bring it to an end."

TWO ANALYSTS ARE BETTER THAN ONE

How more coverage moves stocks

Why does a stock tend to move higher when a Wall Street analyst issues a buy recommendation? Presumably, because the analyst is bringing new information to the market. Thus, you might expect that a stock would jump the most when an analyst is initiating positive coverage of a company that hasn't been followed and recommended by one of his peers in the past.

That's not quite the way it works, report Bruce C. Branson and Donald J. Pagach of North Carolina State University and Daryl M. Guffey of East Carolina University. The three researchers looked at some 277 positive initiations of coverage by analysts at 20 Wall Street brokerages in 1992. On average, they found that previously uncovered stocks jumped by about 3.1% relative to the market on the days when an analyst initiated coverage. But the market reaction was even stronger when an analyst initiated coverage of stocks that were already lightly covered by several—three to six—of his peers. In those cases, shares jumped by 6% to 7%. With more than six analysts the positive effect was much weaker.

Those results indicate that investors react positively when an analyst initiates coverage of an unfollowed stock but wait for confirmation by several analysts before they really pile in. Once a company is heavily followed, however, one more analyst's views bring little added information to the market.

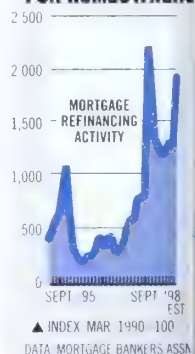
THERE'S MONEY IN MORTGAGES

And a refinancing surge will tap it

Are economists underestimating the potential impact of lower interest rates? Mortgage refinancing could be a powerful antidote to an economic slowdown. With 30-year mortgage rates near 6.75% and falling, economist Mark Zandi of Regional Financial Associates estimates that close to half of the \$3.6 trillion in outstanding mortgages are good candidates for refinancing—and the number would approach three-quarters if the mortgage rate hits 6.5%.

Mortgage refinancing doesn't only provide consumers with extra usable income via lower monthly payments. In many cases, says Zandi, homeowners are choosing to cash out their equity—that is, to increase the size of their mortgages and thus obtain a sizable check that can be used to pay off higher-interest debt or finance major purchases.

A CASH COW FOR HOMEOWNERS



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BY JEFFREY E. GARTEN

WHICH FINANCIAL HEAVYWEIGHTS WILL SURVIVE THE SHAKEOUT?



LONG VIEW:
Four global powerhouses will emerge: Citigroup, Morgan Stanley, Goldman Sachs, and—way in front—Merrill Lynch

As the downturn in global markets knocks 30% to 50% off the value of some of the world's biggest banks and brokerage firms, and as slower American growth portends even more pain, look for many Wall Street firms to cut back on overseas business and staff. In the months ahead, the headlines will focus on Wall Street's current wounds. It is becoming fashionable to look at Asia, Russia, and the Dow Jones industrial average and conclude that globalization is stalled or even going into reverse gear.

But the more lasting story is the international expansion of a handful of banks and brokerages. To be sure, many emerging markets could remain depressed for the next three to five years. But the top financial powerhouses are already preparing for the next wave of globalization—a wave that will involve reorganizing worldwide industries such as telecommunications and automobiles, managing trillions of dollars in pension funds from Germany to China, helping to restructure Japan, participating in a new European merger wave, and underwriting the reemergence of countries such as South Korea and Brazil in global capital markets.

LEVIATHANS. Which players on Wall Street and in other centers are best equipped to emerge as successful global giants? Here is a quick guide to the top four seeds and the likely champion.

The soon-to-be-formed Citigroup will certainly make the semifinals. Made up of the world's best-known banking name, Citibank, as well as Travelers Group and investment bankers Salomon Smith Barney, it could become the first global financial supermarket, providing everything from car loans to advice on mergers to more than 1 billion customers. But its success rests on the untested assumption that clients from New York to New Delhi want one-stop financial shopping, and its Achilles' heel could be the sheer complexity of managing so many different business cultures.

Morgan Stanley Dean Witter, the product of a recent merger, should also make the semis because it has a major presence in investment banking, trading, and asset management, and it possesses strong institutional and retail sales capabilities. But it has yet to make bold moves to shore up its international franchise, such as a major acquisition in Europe or Asia. And the Morgan Stanley and

Dean Witter components of the firm are not yet fully integrated—a potential liability in orchestrating complex global operations.

Goldman, Sachs & Co.—which plans to go public in November—will surely be a tournament finalist. It has the most savvy bankers, the most prestigious client base, and an extraordinary record of profitability. But it is not certain whether Goldman can maintain its cohesive culture if—as is likely—it uses the capital from its flotation to make big acquisitions. Also, like Salomon Brothers and Morgan Stanley, Goldman may lose some of its top talent when it goes public.

Merrill Lynch & Co. is far and away the No. 1 seed. This may come as a surprise to those with outdated perceptions of Merrill being a gray conglomeration of retail brokerage operations. And recent trading losses have surely hurt. But since the early 1980s, it has risen to the first or second position in every major category, from equity and debt underwriting to mergers and acquisitions. It has enormous assets under management, has achieved solid balance among its various revenue streams. It has moved aggressively to plant its stake in Europe, Canada, Japan, Southeast Asia, and Australia.

DEEP KEEL. The key to Merrill's current and future success is what any winner in the global sweepstakes will need: a multinational management team with depth, wide-ranging skills, and seamless internal communications. Its executive committee averages more than 15 years' experience at Merrill Lynch. It has spent the past 10 years building teamwork among product groups and geographical units. It has mastered the art of acquiring foreign firms and assimilating them into its own culture. It has found a good balance for centrally controlling risks while encouraging entrepreneurship. Says Professor Sam Hays of Harvard business school: "In terms of managing a global financial operation, Merrill is a decade ahead of the pack." Of course, the race to the top could be disrupted by surprising dark horses—as might emerge from the possible merger between Deutsche Bank and J.P. Morgan. But unseating today's top four will not be easy.

The doomsayers are having their day in shaping perceptions about the unraveling of emerging markets in the global economy. But here's a better bet: Pay attention to the long-term strategies of Merrill and its rivals.

Jeffrey E. Garten is dean of the Yale School of Management. A former investment banker, he was Under Secretary of Commerce for International Trade in the first Clinton Administration (jeffrey.garten@yale.edu).

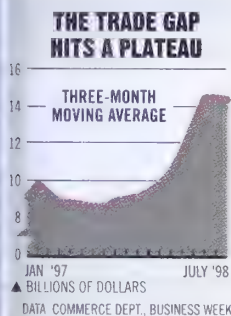
BY JAMES C. COOPER & KATHLEEN MADIGAN

A TRIPLE WHAMMY SPELLS THE END FOR HEADY EXPANSION

Slumping global growth, profits, and markets mean sluggish times

U.S. ECONOMY The glory days of the 1990s business cycle are fading—fast. Say goodbye to those heady times of 4% growth and double-digit profit gains. Even consumer inflation has stopped falling. And amid an economic slowdown, productivity growth is a good bet to taper off as well. The way things are starting to add up, 1999 could be the toughest year yet for this 7½-year expansion.

Much of the latest data confirms the new tone of the outlook. Housing remains strong but has probably peaked. The trade deficit is in a holding pattern but will likely worsen (chart). Most important, domestic demand, especially capital spending, is set to slow in the face of more restrictive financial conditions. The news is not a recipe for recession, mind you—at least not yet. Several indicators, including mortgage loan applications, nonauto retail buying, and jobless claims, continue to signal strength.



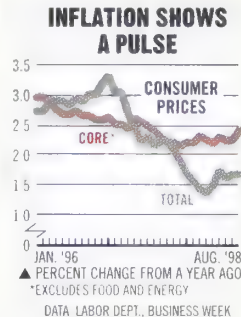
Federal Reserve chairman Alan Greenspan acknowledged this dilemma when he spoke before the Senate Budget Committee on Sept. 23. Greenspan's appearance was significant since it came during the additional "black-out" period, the week before a policy meeting when Fed officials do not speak publicly.

In his speech, Greenspan said again that the U.S. could not remain "an oasis of prosperity" amid global troubles. If anything, he said that, in just a few months time, the crisis has begun to restrain the U.S. economy and those effects "are likely to intensify." His speech seemed to signal his leaning toward an interest-rate cut at the Fed's policy meeting on Sept. 29 (page 42).

RATE CUT might not be that simple, however. Inflation hawks at the Fed will argue that even if gross domestic product growth slows to its noninflationary trend of 2½%, that pace is still strong enough to keep labor

markets tight and lift wage growth at a time when productivity is very likely to slow. So far, rising labor costs have had their biggest impact on profits, but a few businesses have been able to raise prices. Consumer prices for all goods and services rose 0.2% in August, the same gain as in July. The performance was the same for core prices, which exclude food and energy costs.

The hawks, though, will point out that, despite the hype over global deflation, core consumer inflation has actually risen slightly in recent months. Over the past year, total inflation is up 1.6%, while the core rate has picked up to 2.5%. Both rates are still tame, but annual core inflation is now the fastest in more than a year (chart).



On Capitol Hill, however, Greenspan made the case that, going forward, inflation will remain tame. He said that since the last Fed meeting on Aug. 18, "deteriorating foreign economies and their spillover to domestic markets have increased the possibility that the slowdown in the growth of the American economy will be more than sufficient to hold inflation in check." Nonetheless, Greenspan also acknowledged the Fed must remain alert to the inflationary consequences of labor shortages and rising compensation.

TIGHT LABOR MARKETS are not the Fed's only inflation concern. Policymakers also know that the current rapid deterioration in the U.S. trade position could eventually set up a reversal in the three-year, 25% surge of the trade-weighted dollar. The strong greenback has been the primary deflationary force in the U.S. inflation rate, because it has fostered the sharp drop in import prices. Interest-rate cuts by the Fed could trigger a steep decline in the dollar. Already, the trade-weighted dollar has declined by more than 5% in the past month just on hopes of a rate cut, so import prices may well stop falling this autumn.

The outlook for the trade gap, however, is not good. The trade deficit in July widened to \$13.9 billion, from \$13.6 billion in June. Exports shrank for the fourth consecutive month, dropping 1.3%, to \$75.4 billion. Imports fell a smaller 0.8%, to \$89.3 billion.

When measured as a three-month moving average,

the trade gap has held at \$14.5 billion since May. But more erosion is in the cards. First of all, nearly all of the recent stability comes from the import side of the trade ledger. Growth in imports from the Pacific Rim nations has slowed during 1998 despite their cheap currencies. The problem is that many of these economies are unable to get financing for their export operations. As soon as the money becomes available, import growth will pick up.

In addition, exports, hit by prospects for slower world growth, face a tough road ahead. Already, real merchandise exports in July were down 3.5% from a year earlier, and the decline so far this year is the worst since the 1981-1982 recession.

PART OF THE FEAR of a sudden weakening in the dollar stems from the growing U.S. current-account deficit, the broadest measure of the country's international obligations that includes the widening trade gap as well as the increasing financial obligations to holders of U.S. debt. This deficit hit a record \$56.5 billion in the second quarter. It now equals 2.7% of GDP, and it will very likely surpass 3% in coming quarters. At that level, the currency markets usually demand a correction in a country's external deficit via a weaker currency, similar to what happened in the U.S. in the mid-1980s, when the current-account gap hit 3½% of GDP.

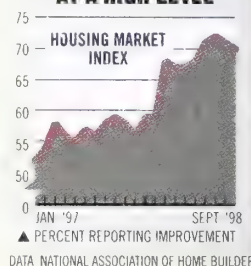
The trade picture is eroding so rapidly because U.S.

domestic demand remains stronger than almost anywhere else in the world. Both businesses and consumers have contributed to that strength, but the poor outlook for profits, as well as a credit squeeze, suggests capital spending's vigor is starting to wane. Capital spending is the economy's most vulnerable sector right now. Consumers, however, still seem confident and flush enough to keep buying, although at a much slower pace than the first half's 6% gallop.

One area where consumer interest remains keen is housing. Mortgage applications for homes have surged 16% in the past four weeks, boosted by 30-year mortgage rates below 7%. Little wonder that home building will probably not fall back much from its recent highs. Housing starts fell 5.5% in August, to an annual rate of 1.61 million, but July's figure of 1.71 million starts was an 11-year high, and builders remain quite upbeat about their prospects (chart).

Like the housing index, many other readings on the economy remain just below their recent peaks. But the going will get tougher this fall and winter, when many businesses will have only their memories of better times to keep them warm.

HOUSING REMAINS AT A HIGH LEVEL



THE EURO ECONOMY

FOR THE EURO, A DIFFICULT DEBUT

Just as the Jan. 1 launch of the euro nears, the 11 member economies are bracing for a slowdown that could threaten their two-year recovery. With global turmoil expected to hit exports, economists have downgraded 1999 forecasts.

Developing countries take about 40% of the European Union's exports, and they have accounted for a big chunk of export growth, say economists at Morgan Stanley Dean Witter, who cut their 1999 euro-area growth forecast from 2.7% to 2.2%. But it's not just Asia and

Eastern Europe. Demand in Britain, which takes 20% of the Continent's exports, is flagging,

and the huge U.S. market will deteriorate. Moreover, the euro's estimated value has already risen 5% this year, due to weaker emerging-market currencies. With the dollar slipping, the euro's competitiveness will dip further.

The key word in the outlook, though, is slowdown, not stop. Euro-area growth is shifting toward domestic demand, and consumer spending should remain resilient. Clearly, slower growth will wipe out any prospect of cutting the region's 11% jobless rate. But low

inflation will support real incomes, and cheap interest rates will boost housing and related businesses.

The sector expected to be slammed hardest is business investment, especially in manufacturing, where weaker exports will hammer output and profits.

The betting is that the European Central Bank will establish the euro-zone interest rate at the current Bundesbank repo rate of 3.3% (table). Spain and Italy are the best positioned for growth in 1999, with Spain already showing considerable momentum. Both will benefit from the rate cuts required for convergence. Germany and France are likely to see growth suffer the most. Germany will take a double hit from eastern Europe, given its export ties and loan exposure. The fortunes of France and Germany will set the tone for euro-land, since the two are responsible for some 55% of the area's output.

THE EURO-11 HEAD TOWARD CONVERGENCE

	CURRENT POLICY INTEREST RATE
AUSTRIA	3.20%
BELGIUM	3.30
FINLAND	3.40
FRANCE	3.30
GERMANY	3.30
IRELAND	6.19
ITALY	5.00
LUXEMBOURG	3.30
NETHERLANDS	3.30
PORTUGAL	4.50
SPAIN	4.25

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The global crisis isn't going away—and U.S. profits will suffer

The emerging-markets crisis has settled in for an extended stay. Around the world, markets are drying up, prices are contracting, and economic development is slowing. And with the major industrialized nations still putting together a rescue plan, there is no sign of improvement on the horizon.

Much of the U.S. economy remains unscathed, but the deepening crisis has become an immense challenge for American business. "The world economic crisis is front and center of what we're thinking about," says General Motors Chairman and Chief Executive John F. Smith Jr.

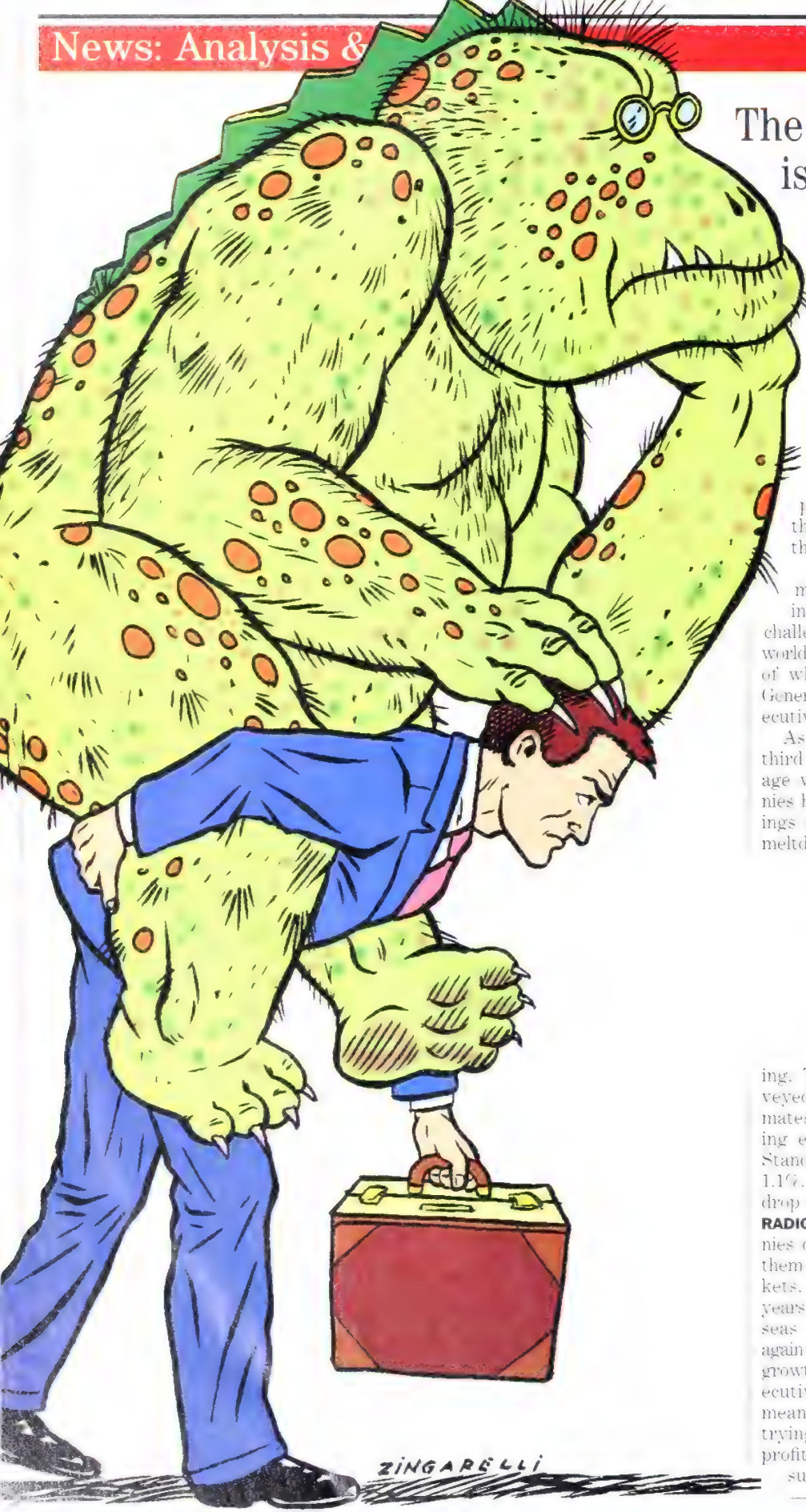
As companies close the books on the third quarter, the extent of the damage will become clearer. Many companies have already issued earnings warnings because of the emerging-markets meltdown and the deflation it is spread

IT'S

ing. That has prompted analysts surveyed by First Call Corp. to slash estimates: Now, they project that operating earnings of the 500 companies in Standard & Poor's stock index will fall 1.1%. That would be the first quarterly drop since 1991.

RADICAL MOVES. What are U.S. companies doing to cope? Surprisingly few of them are pulling back from foreign markets. Three or four years from now, overseas markets will again provide the best growth potential, executives say. In the meantime, they are trying to preserve profits—using measures usually re-

COPING WITH THE HAVOC OVERSEAS



erved for domestic recessions, including layoffs and reductions in capital spending.

A prime example is 3M. For years, it counted on global markets to produce double-digit earnings growth. But 3M's sales, whacked by softness in Asia and the strong dollar, fell 1% in the first half, while profits declined 5%. So on Aug. 27, Chief Executive Livio D. Simone launched 3M's most radical restructuring in two decades. The company is laying off 6% of its workforce, cutting marginal businesses, and taking a pretax charge of up to \$500 million. Similarly, on Sept. 22, Crown Cork & Seal Co. said it would slash 7% of its workforce, cut capital spending, and buy back shares. And the pain is spreading to financial services: Citicorp and Travelers Group Inc. will cut jobs after their announced merger, which won U.S. regulatory approval Sept. 23. Wall Street is racing for other layoffs as traders tally merging-markets losses. Already, corporate layoffs are 37% ahead of 1997, say outplacement specialists Challenger, Gray & Christmas Inc. (page 40).

HERE'S BOTTOM? Few expected that the Asian meltdown would hit the U.S. this way. Then again, when the crisis erupted last summer, "the prognosis was you might see an 18-month period before recovery," explains Diann H. Painter, chief economist at Mobil Corp. "Now, it looks as if for Asia, we're looking at 2 to 2½ years of very slow to no growth."

Ever-bullish Wall Street analysts insist that the third quarter will mark the bottom. Indeed, analysts surveyed by First Call still project a 10.3% jump in profits for S&P 500 companies in the fourth quarter, and 19% next year.

But those are "pie-in-the-sky estimates," scoffs Charles L. Hill, First Call's research director. Indeed, the gap between economists' expectations and these forecasts is "as striking a divergence as I've seen in 20 years," says economist Robert J. Barbera at broker Hoenig & Co. At best, we'll see a single-digit jump in U.S. corporate profits next year, predicts Nariman Behraves, chief international economist for Standard & Poor's DRI.

And if the Latin economies tumble, earnings will go "into negative territory."

If that happens, far more companies are going to "have to think about cutting back," warns Hill. And those cutbacks could brake the 7½-year-old U.S. expansion. Even DRI's best-case scenario assumes layoffs will drive the U.S. unemployment rate to 5.5% next year, up from 4.5% now. Similarly, U.S. capital spending "will be hurt pretty dramatically," warns Behraves. At best, DRI expects capital

certain sectors of manufacturing, such as heavy-equipment makers. But imports are depressing prices of everything from steel to autos in the U.S. "As economies crash around the world, everyone seeks to export to the land of the free," complains GM CEO Smith. GM is now offering huge incentives to keep up with rivals.

Mazda Motor Corp. has slashed \$5,550 from the sticker price of its Millenia S. Ford Motor Corp., meanwhile, has cut the base sticker price of the '99 Taurus by \$1,000.

"CASH CRUNCH." Companies are increasingly cutting back their capital-spending plans. Morgan Stanley Dean Witter analyst Jay Deahna expects chipmakers to pare their capital spending by 35%, or

\$14 billion, this year—a staggering blow to makers of semiconductor equipment such as Applied Materials Inc., which has already announced a major layoff. Motorola Inc. has postponed an entire \$3 billion chip plant. "In this market...you get into a cash crunch," says U.S. Steel Group President Paul J. Wilhelm. U.S. Steel has already idled mills in Gary, Ind., and Loraine, Ohio.

To be sure, not every industry is scaling back—or needs to. "We're having

EARNINGS FORECASTS ARE FALLING



WOMEN GET UGLY

The problems have since spread, threatening Latin America. If Brazil collapses, warns GM Chief Economist G. Mustafa Mohatarem, the U.S. auto industry—and many other companies—will be hit far harder than in Asia. In all emerging markets, fear is inhibiting consumers, adds Gillette Chairman and CEO Alfred M. Zeien, who admits, "I don't know where the bottom is."

spending to grow by 6% next year, down from a double-digit rise in 1998. If the global economy worsens, growth in capital spending could slip to less than 3% next year and then decline in 2000.

Meanwhile, the effects of the global crisis are spreading far more deeply than Corporate America expected last fall. Initially, the damage was confined largely to commodity businesses and

the best year in 20 years," says David Seiders, chief economist for the National Association of Homebuilders. Interest rates are low, and the Asian crisis has reduced lumber prices, he notes.

And virtually everyone still sees enormous opportunities in emerging markets long-term. Short-term, some companies are trimming their sails. On Aug. 20, Federal Express Corp. announced that it

DUPONT

Third-quarter earnings near the low end of expectations. Is productivity as delayed or halted capital spending.

POLAROID

First-half sales and profits off sharply due to the global crisis. Accelerating plans to trim 1,800 people, or 20%, from workforce, and halting shipments to Russia.

3M

To adjust to falling demand overseas, the company plans layoffs that will result in a third-quarter charge of as much as \$500 million before taxes.

WALT DISNEY

With lower demand for consumer products in Asia and rising production costs, Disney is reviewing its consumer-products structure to reduce overhead.

would put its Asian expansion plans on hold. And Polaroid Corp. recently stopped all of its shipments to Russia.

Still, retreat is the exception. At Corning Inc., the Asian recession and the weak yen have cut prices for the company's core product by 30%, says CEO Roger G. Ackerman. "But we're not backing down," he says. "Our strategy is to fight like hell." To cut costs, Ackerman has instead reduced Corning's salaried head count by some 600,

or 10%. Indeed, some multinationals, such as Wal-Mart Stores Inc., see this as an ideal opportunity. Wal-Mart remains "committed to being more of a presence in [Latin] markets," says CEO David Glass. "What we are learning is how to operate in volatile economies."

Indeed, the crisis is teaching executives to view globalization more warily. "Many U.S. executives were too naive," says Harvard business school professor Rosa-beth Moss Kanter. "Asia and Chi-

na were really overhyped." Going forward, companies will have to be far more realistic about the promise—and peril—of emerging markets.

By William C. Symonds in Boston with Kathleen Kerwin in Detroit and bureau reports

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IS THE JOBS ENGINE STARTING TO SPUTTER?

Will the strongest U.S. job market in a generation be the next victim of emerging-markets turmoil? Manufacturers that rely heavily on export markets have been feeling the pinch for a year. But now, as the spreading malaise begins to affect bigger chunks of the U.S. economy, deeper job cuts could be in store.

Already, total layoffs in the first eight months were 37% ahead of last year's pace, according to Challenger, Gray & Christmas Inc., a Chicago outplacement firm. Only 1.9 million jobs were added, compared with 2.2 million for the same period a year ago—a 14% slower growth rate, according to the Bureau of Labor Statistics' survey of company payrolls. And the drop was bigger in service industries, which grew by 920,000 jobs through August, 19% less than in the same period last year, according to the BLS.

ANXIOUS. The slowdown hasn't raised the jobless rate yet, because fewer new workers are joining the labor force. But if job cuts continue at their current pace, today's 4.5% unemployment rate may soon drift higher, economists say. If it does, consumer confidence could take a hit. "The job market is still good, but workers' anxiety level may jump if the layoffs continue," says John A. Challenger, vice-president of Challenger Gray.

Challenger Gray reckons that 359,000 positions were eliminated through August. That's just 11% below the peak in 1993. While factory workers have borne the brunt of these downsizings, also included are employees of such companies as Met-



MERGER PAIN

Deal mania is driving many layoffs. Citicorp and Travelers plan job cuts after they merge

ropolitan Life Insurance Co., which on Sept. 8 said that it will cut 2,000 of its 27,000 U.S. jobs.

Merger mania is the other force behind rising layoffs. The num-

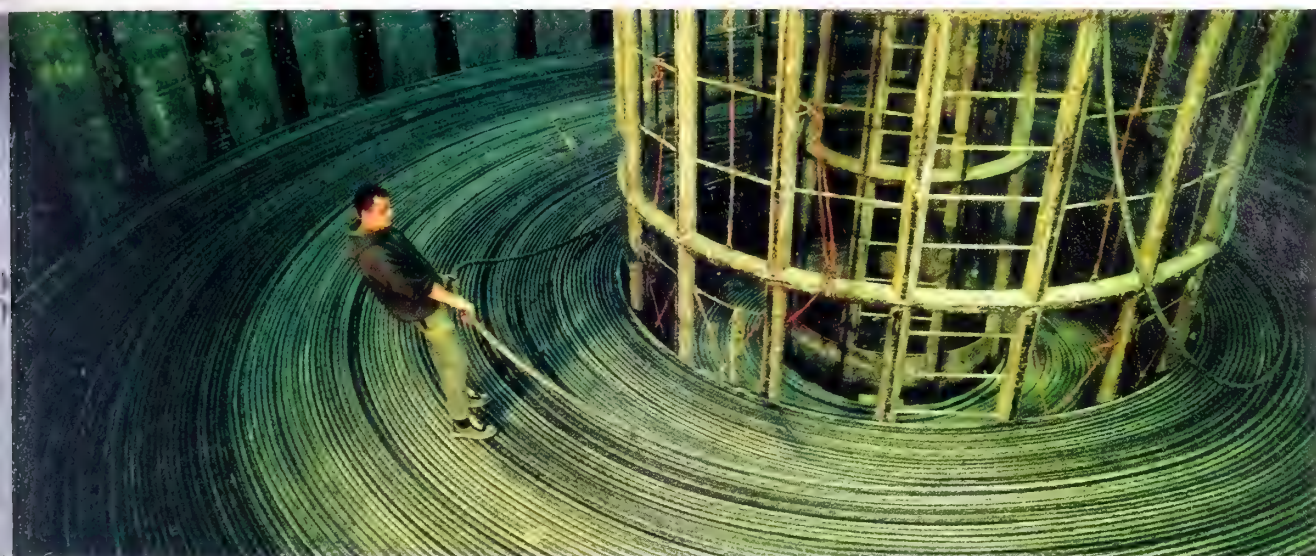
ber of mergers so far this year has jumped by 8% from last year, to 7,999, according to Securities Data Co., a Thomson Corp. unit. Companies are making deep post-merger cuts to reduce costs, says Jack W. Prouty, a partner at KPMG Peak Marwick LLP. And since it can take a year to complete reductions, cuts from announced mergers may further swell the layoff numbers, he says.

Take Citicorp's merger with Travelers Group Inc., which is expected to be completed soon. The two financial companies plan significant reductions to their combined workforce of 160,000—layoffs of up to 5%, say analysts. Part of the calculus is that the company's Asian expansion will be slower. If there's no improvement in Asia—where the combined company had hoped for fresh growth—the numbers could rise.

As these layoffs add up, the employment rate could slip—and there are already some worrisome statistics that are pointing the way. In addition to company payrolls, the BLS also surveys the number of jobs per household every month. The two numbers often diverge, but this year the household measure of jobs has lagged further than usual behind the payroll one. Through August, it shows a net gain of just 400,000 jobs, one-fifth the gain in the payroll series. BLS officials say that they can't yet account for the discrepancy. But "the household survey may be an early warning sign of a job slowdown," says Fleet Financial Group Chief Economist Nicholas S. Perna.

True, the labor market is still tighter than it has been in decades. But after years of falling unemployment, the startlingly low jobless rate may soon work its way back to more familiar turf.

By Aaron Bernstein in Washington



THE GLOBAL ECONOMY

ASIAN FLU, EUROPEAN SNIFFLES

ragging profits at blue chips show its economies aren't immune

In just a matter of weeks, Europe's business climate has been transformed. As recently as mid-July, investors thought the Continent was on the verge of a long-awaited boom. Like their U.S. counterparts, European companies seemed to shrug off Asia's economic meltdown for nearly a year. But ever since Russia's debt default on August 17, the rot that began in the emerging markets has begun seeping across Europe's borders and into the results of its major corporations.

Withering demand from Asia, Latin America, and Russia is cutting into growth forecasts. The chances of a serious slowdown in the U.S., another key export market, have also risen. And ripple effects from the troubled global economy are likely to pressure Europe's corporate chieftains, perhaps forcing cutbacks in spending and hiring plans.

In the span of a few days in September, the markets were slammed by a series of nasty surprises from several blue-chip companies (table). On Sept. 17, Alcatel CEO Serge Tchuruk announced that the company's major European customers were slashing orders by up to 50%. Then, Dutch conglomerate Philips Electronics, British entertainment giant I Group, and Royal Dutch/Shell Group said their upcoming results are likely to be worse than expected. "The outlook is getting bleaker," says James E. Smith, an equity strategist at BT Alex. Brown in London.

Each burst of bad news sends another shudder through the investment community. "People are looking for the next downgrade, not knowing where it is going to come from," says Gary Dugan, European equity strategist at J.P. Morgan Securities Ltd. in London. Dugan expects corporate earnings across Europe to rise by just 5% next year—a big drop from the 18% Morgan was forecasting in July.

While some companies are seeing improving results, Europe seems full of risks. Currencies of the 11 countries expected to enter the European Monetary Union are rising against the dollar and sterling, making the region's goods less competitive. Britain, which takes roughly 16% of the EMU countries' exports, may have almost no growth next year.

Manufacturers' stock prices have been particularly hard hit. Fiat, for instance, was full of fire a few months ago after pouring \$2.2 billion into auto plants in Brazil and Argentina. But with Brazil flirting with financial catastrophe, those investments no longer look so brilliant. Weakness in Latin America contributed to an 11.2% drop in operating earnings in the first half.

ALCATEL: News of order cutbacks by big customers sparked a stock slide

Analysts worry that lost sales from emerging markets will lead to a turnaround at home. Bruce Kasman, J.P. Morgan's chief European economist, now expects European companies to increase capital spending by 5% next year rather than 10%. That could affect hiring and consumer spending. Morgan has cut its average 1999 growth forecast for the 11 countries planning to adopt the single currency to 2.5% from 3%. BT Alex. Brown expects less than 2% growth in Germany and France next year.

JOB LOSSES. On Sept. 18, Royal Dutch/Shell Chairman Mark Moody-Stuart warned that the global business climate in the second half of the year will be "significantly worse" than in the first half. That, he said, will prompt Shell to

speed up its disappointingly slow restructuring program. Redundant local headquarters in Britain, France, Germany, and the Netherlands are to be closed, with some associated job losses. Assets may be written off.

Despite the pessimism, Europe could actually outperform the rest of the world. Merrill Lynch & Co., whose experts believe the

biggest global growth contraction since the oil crisis of 1973-74 is in the works, is still relatively bullish on Europe, largely because of the coming single currency. But the robust recovery that Europe was hoping for after years of stagnation could turn out to be a grand illusion.

By Stanley Reed in London, with bureau reports

WARNINGS WEEK

Within five days, four major companies warned that earnings will suffer as a result of the emerging-markets crisis

SHELL	Sept. 18
ALCATEL	Sept. 17
EMI	Sept. 21
PHILIPS	Sept. 21

THE ECONOMY

RATE-CUT TALK ISN'T JUST TALK

Greenspan all but guarantees a cut. But how much, and when?

It's no longer a guessing game about whether the Federal Reserve will lower interest rates. The only question remaining: When?

Federal Reserve Chairman Alan Greenspan's somber testimony before Congress on Sept. 23 on the topic of the worsening world economy all but guaranteed that a cut in interest rates will take place this fall, perhaps as early as Sept. 29, which is when the Federal Open Market Committee is scheduled to meet. Fed watchers are looking for a 0.25% cut in the 5.5% overnight federal-funds rate, although a reduction of one-half a point can certainly not be ruled out.

NO BODY BLOW YET. Greenspan, who went to great lengths to describe all the risks that are currently facing the U.S. economy as a result of the deepening global meltdown, must still convince the Fed inflation hawks that the cut is needed now—since the economy has yet to take a body blow. The Fed chief's arguments: Manufacturing is softening, profits are stalling, and companies are having a tougher time raising funds. Indeed, as Greenspan testified, the Fed was trying to head off a potential banking crisis sparked by massive hedge fund losses in emerging-markets (right).

Many Fed watchers expect to see a half-point cut, but even a quarter-point move could have widespread impact. Any cut would push down the value of the U.S. dollar, thus easing the crunch on American exporters. But more important, a falling dollar would give breathing room to Latin American and Asian borrowers with dollar-denominated debt. "A drop in U.S. rates would directly help these countries," says Michael R. Englund, chief economist at Standard & Poor's MMS.

And the assurance that a rate cut is really in the works operates as a tonic: The Dow Jones industrial average soared 257 points on Sept. 23. Says former Federal Reserve Vice-Chairman Manuel H. Johnson Jr.: "A rate move puts a floor under all this global depression talk."

By Dean Foust in Washington



FINANCE

A \$3.5 BILLION TRANQUILIZER

Why the Fed took a hand in crafting an LTCM bailout plan

The turmoil in global markets rolled into the New York Federal Reserve on Sept. 23. In an emergency meeting at the stone fortress in the heart of the financial district, two dozen bankers from the world's leading financial firms convened to prevent the failure of hedge fund giant Long Term Capital Management—and head off a possible market panic, say market sources. As a measure of the gravity of the meeting, Goldman, Sachs & Co.'s co-chief executive Jon S. Corzine and J.P. Morgan & Co. Chairman Douglas A. Warner III were there.

LTCM, founded by former Salomon Inc. traders including John Meriwether, had already lost \$2 billion of its \$4 billion in the first eight months of 1998, and was facing liquidation due to huge losses in fixed-income markets around the world. The plan, which was reached on the evening of the 23rd, called for a consortium of major banks and investment firms to put up more than \$3.5 billion in new equity for LTCM. In return, LTCM will give up control to an oversight committee that will run the firm.

THE FED: When banks balked, LTCM called in the heavy artillery

Members will include representatives of Goldman Sachs, Merrill Lynch, Morgan Stanley, Dean Witter, Traveler Group, and UBS. "We greatly appreciate the willingness of the consortium to provide capital," Meriwether said in a statement.

The hedge fund's crisis began around Sept. 18. Bear Stearns & Co., an LTCM lender, had asked the fund to reduce trading positions because the value of bonds LTCM had pledged

as collateral had fallen, sources say. That forced LTCM to find new financing. The firm turned to a \$500 million committed credit facility that LTCM had lined up for just this situation, say market sources.

But some of the banks in the syndicate balked at letting LTCM draw down their credit, say market sources, because LTCM was close to defaulting on some loan covenants.

That's when LTCM, whose partners include former Federal Reserve Vice-Chairman David W. Mullins Jr., called the Fed. One source says LTCM first asked the New York Fed to force its banks to honor their commitments. In any event, the prospect of an LTCM failure brought swift attention from the Fed. "This could spook the market if this thing went down and nobody did anything," says Roy C. Smith,

a finance professor at New York University.

On the evening of Monday, Sept. 21, a meeting was held at LTCM's Greenwich (Conn.) headquarters with its banks. The initial proposal was for

With losses mounting, LTCM faced liquidation

the banks to cough up \$250 million each to buy LTCM for \$4 billion, say market sources. Some balked, but others pressed for a quick resolution.

Few traders missed the irony: Even a news of the bailout plan emerged on CNBC on the 23rd, Fed Chairman Alan Greenspan was warning Congress that the worsening global crisis required action by the U.S. Both in public and behind closed doors.

By Leah Nathans Spiro, with Gar Silverman in New York and Dean Foust in Washington

BURIED IN NOMURA'S REAL ESTATE RUBBLE

More fallout from the mortgage-backed-securities meltdown

Observant investors at the Capital America conference on Aug. 27 noticed something weird going on. The conference, hosted by Ethan Penner, the aggressive banker who had made Nomura Securities Co. a top player in commercial real estate finance, was the event of the year for people interested in the arcane but lucrative world of commercial mortgage-backed securities. The business of securitizing commercial mortgages had made 37-year-old Penner one of the highest-paid people on Wall Street, earning as much as \$45 million a year. But that night, there was Penner, who had not persuaded Nomura to put its CMB business into a separate Capital Company of America subsidiary, sitting at the same dinner table with the Nomura brass—yet neither camp was saying a word to the other. Soon enough, it became clear why there was a chill. On Sept. 19, Nomura Holding America, owner of Capital America, announced that it had accepted Penner's resignation. Three days later, Tokyo-based Nomura Securities announced that it would inject \$380 million in equity and \$150 million in subordinated debt into Nomura Holdings America. Capital America, Nomura says, will show a \$275 million after-tax loss over the six months ending on Sept. 30. Part of the parent company's infusion will be used to bring Capital America's capitalization back to the \$1 billion it started with when the unit was made a separate subsidiary in June. Says William Wraith IV, co-CEO of Nomura Holding America, in a press release: "This demonstrates that we and our parent fully support Capital America and its new management." Capital America is just the most visible casualty in an increasingly shaky market. Investment houses, including First Boston, Lehman Brothers, and



Capital America account for almost 70% of the loans backing CMB issues. And because they don't want to sell into a market where demand is scarce, they are sitting on billions in inventory that may well be overvalued.

PRICKLY HEDGES. Making matters worse, the fixed-income markets have turned on these firms. They had tried to protect against rising interest rates—and falling bond prices—while they held the CMBS. It's common for dealers to use hedges in this market, where it can take months to make loans, have them rated by credit agencies, and then sell them to investors. Firms are desperate to limit the risk that market conditions will change while they're holding the assets. So they routinely hedge against the risk of rising interest rates by selling Treasury bonds short. The theory is that if rates rise, losses on the value of the loans they hold would be offset by the rising value of their hedges—and vice versa.

Not this time. With the rest of the world collaps-

ing, investors are paying up for Treasuries. That means prices on Treasuries are rising, not falling. But buyers are staying away from other fixed-income securities. So despite the fact that delinquencies on commercial loans are at a 28-year low, prices for CMBS have not rallied along with Treasuries, and the spread between AAA-rated CMBS and 10-year Treasury bonds has almost doubled in the past six months, to 130 basis points. As a result, the firms' losses from hedges have mounted, and the value of the CMB securities has remained flat or declined. "There's no successful hedge for [yield] spread risk," says Andy Stone, the head of Credit Suisse First Boston's CMB division.

Now, the problems are coming home to roost—and not just at Nomura. WMF Group, a real estate lender based in Vienna, Va., took a \$30 million loss on Aug.

FALL FROM GRACE

After sparring with the brass at Nomura, Ethan Penner resigned on Sept. 19

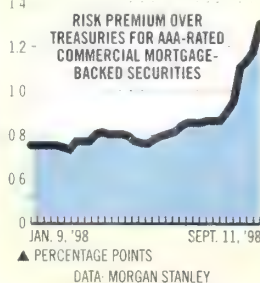
31, when it sold a \$691 million portfolio of loans to Merrill Lynch & Co., nearly wiping out its \$40 million in capital. "This is the 100-year flood in our industry," says Michael Ketcham, WMF's chief financial officer. If WMF's experience is typical, Wall Street firms holding most of the estimated \$35 billion in commercial loans slated to come to market this year could face losses of \$500 million or more on the value of the CMBS themselves and on the attempted hedges.

Some firms, eager to keep their inventory from expanding further, have simply stopped making new real estate loans. In early September, Credit Suisse First Boston announced it would

cease new lending until conditions in the CMB market improve. Others have since followed suit. It remains to be seen what Nomura will do. But one thing is for sure: Nomura and others will feel plenty of pain before they see new gains in this market.

By Leah Nathans Spiro in New York and Andrew Osterland in Chicago

RISE IN RISK



COMMENTARY

By Christopher Farrell

THE NET AND EMERGING MARKETS: BOTH WILD, BOTH VITAL

It's dangerous on the frontier—whether you're talking about emerging markets or the Internet. That lesson was driven home painfully this past summer as U.S. equities plunged because of the deepening crisis in Asia, Russia, and, most recently, Latin America. As the market tumbled, the fast-moving companies that are taming cyberspace and creating a new online economy also lost ground.

From the investment euphoria for tulip bulbs in 17th-century Holland to the bubble in biotech stocks in the early 1990s, it's easy to dismiss the market's recurrent manic moods. The mid-'90s stampede into emerging markets certainly looks ill-advised now, and the billion-dollar valuations on Internet companies with little revenue and no profits seem equally preposterous.

But simply wagging a finger at the excesses misses a fundamental point about emerging markets and Net startups. In both cases, we're talking about frontier economies with few rules or traditional guideposts. It's a Wild West where no one really knows what will work and what won't.

This we do know: It would take far longer for these economies to develop without Wall Street's enthusiasm for funding entrepreneurship in the hope of making a financial killing. After all, it's only with hindsight that we really learn which projects were genuinely wacky and which ones were surprisingly sound.

WITHOUT A MAP. The parallels between emerging markets and the Net are striking. Both are trying to cope with difficult transitions without a blueprint. From Russia to Indonesia, state-dominated economies are striving to create private enterprises, stable banking systems, and other institutions vital to sustaining rapid economic growth.

Net companies, meanwhile, are inventing a profit-making cybereconomy

in what once was a noncommercial frontier. Most Net investors have yet to experience the kind of pain that, say, owners of ruble funds are feeling. And although some Web highfliers are ascendant again, more dislocations are inevitable. "In both cases, it's the changing of the rules that is proving so troublesome," says Esther Dyson, a high-tech maven who also advises Russian companies.

And, in both contexts, profits are elusive during the

ties Inc. "The Internet stocks could implode as rapidly as the emerging markets did if the rate of return isn't there."

While great speculative bubbles usually end badly for investors, the underlying economic gains in most cases endure. For instance, in the late 1860s, Europeans invested in the world's biggest emerging market—the U.S. Much of the money flowed into high-risk, high-return railroad securities. But capital fled in 1873 as investors recoiled at the railroads' crippling debt burdens and mounting evidence of widespread corruption,

according to J. Bradford de Long, professor of economics at the University of California at Berkeley. The U.S. economy tanked as a result.

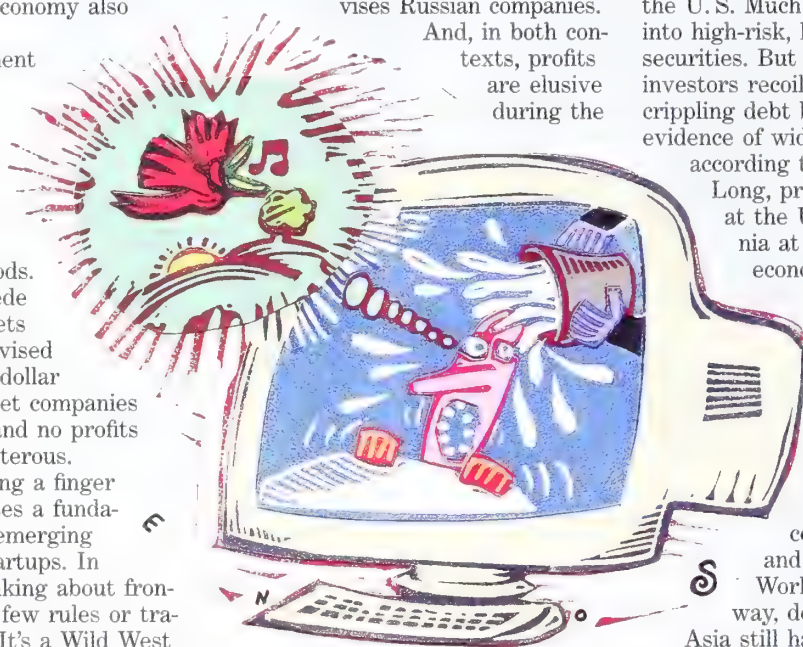
Yet the railroads stayed, a new national infrastructure that played a vital role in the fivefold increase in net national product and a near-tripling in real per-capita incomes between 1870

and the outbreak of World War I. In the same way, despite all the turmoil,

Asia still has a superb workforce and savvy entrepreneurial class, which will eventually translate into genuine market power and economic growth. It's the same with the Net, although, blessedly, the cybercrunch won't cause social fallout on the scale of the emerging-market bust. Companies will disappear, products will vanish, but the Net will remain.

Financial history tells us that stock prices can get far out of whack with the fundamentals—it is the nature of the beast. Pioneers and visionaries often fail. Investment scams and scandals are inevitable along the economic margins. But quality will out. And the frontier economies of the Net and emerging markets are moving closer toward the economic mainstream.

Farrell covers the markets from St. Paul.



FRONTIER HAZARDS

Despite the havoc that follows speculative bubbles, some of the underlying economic advances usually endure

transition. Dealmaking flourished after the collapse of communism and the embrace of laissez-faire economics in emerging markets. But foreign capital fled once investors realized that debts were enormous and earnings nonexistent. Dealmaking is all the rage in cyberspace, even though few Net companies are making much money. "Lots of capital is looking for a get-rich-quick-scheme off the Internet," says Edward E. Yardeni, chief economist at Deutsche Bank Securi-



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COMEBACKS

OH, DO I
LOVE MY iMAC

Is Steve Jobs's hip hit the start of something big at Apple?

**NEWBIE:** More than 15% of iMac buyers may be, like Sherry, first-time PC owners

The eye-catching iMac is reviving a feeling that Apple Computer has not been able to spark in years: love between consumer and computer. In Princeton, N.J., a dozen kids stormed the home of Diane and Bobby Landis Hackett to gawk at the blue, curvy machine. In Laguna Niguel, Calif., 9-year-old Elias Isquith adores his iMac, in part because "it reminds him of the aliens in *Independence Day*," says his mom, Natalie. In Amherst, Mass., 55-year-old music professor Estela K. Olevisky—a self-described computer hater—succumbed. "I liked the look of it, and I'm pleased because it's not cluttering up my desk."

The clutter, for a change, is in the aisles of your local Macintosh dealer. Although it only hit the stores in mid-month, the \$1,300 iMac was the No. 2 best-selling computer in the U.S. for August, after a Hewlett-Packard model, driving Apple's U.S. retail market share from 6.8% in July to 13.5%, says market researcher PC Data. "We sold more iMacs in a short amount of time than

any computer we've ever sold," says Harold F. Compton, chief operating officer of CompUSA Stores Inc.

And it's not just hard-core Apple lovers that are buying. More than 15% of iMac buyers are first-time PC owners, and an additional 12% were converts from "Wintel" models based on Microsoft's Windows, according to ComputerWare, a West Coast chain.

This being Apple, the next question is whether interim CEO Steven P. Jobs can sustain the iMac momentum while keeping other parts of the business on the comeback trail. After weeks of shortages, Apple is now catching up with brisk demand for a new PowerBook laptop, and Jobs is expected to unveil a cheaper portable next spring.

How will iMac fare once the novelty fades? "This computer is a fashion

statement right now, but those things wear off," says Oppenheimer Securities analyst James D. Poyner. "If Apple intends to sell lots of machines based on how they look, that's a pretty tenuous story." The iMac has to hold its own in a market of sub-\$1,000 (and falling) PCs. And Korean-based E-Machines has announced plans to sell an iMac look-alike for less than \$600, say analysts.

Apple would not comment for this article, but its suppliers and dealers tell BUSINESS WEEK that the company plans to build as many as 1 million iMacs by the end of the year—double many analysts' estimates. Analysts figure Apple could sell 750,000 iMacs in the fourth quarter, after moving 250,000 this quarter, and the company may show growth in the Christmas quarter for the first time since 1996.

PRINTING GLITCH. That would be a much needed boost for Apple. Revenues are expected to shrink by 17%, to \$5.9 billion, in the year that ends Sept. 30, and the company continues to lose share in the education and corporate markets. While Apple's dismal record on operations has improved, more must be done. Already, one high-end Mac was tabled and slow PowerBook production caused shortages. And a software bug in the iMac, discovered after the Aug. 14 launch, delayed shipment of peripherals and an adapter kit for Hewlett-Packard Co. printers.

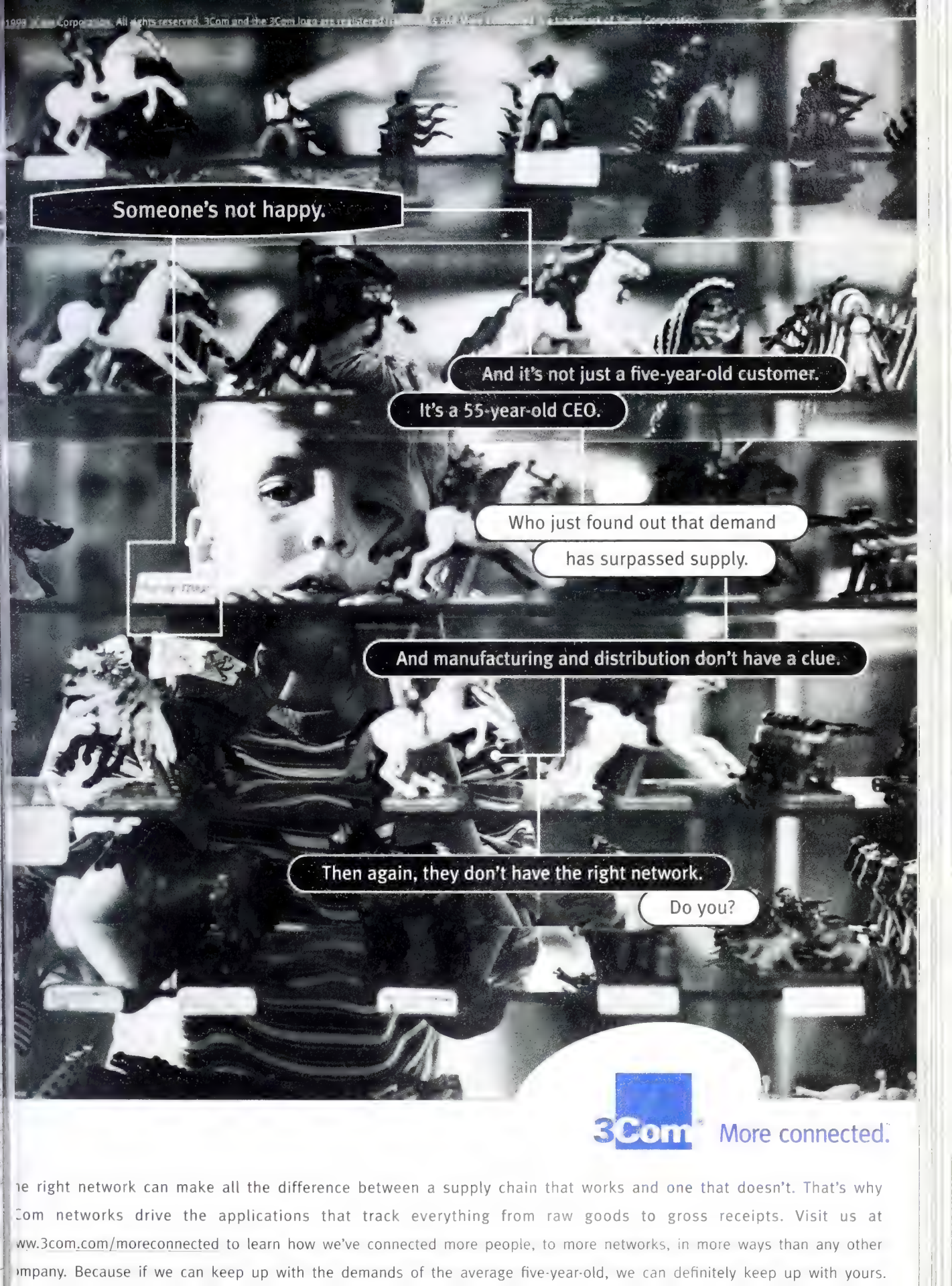
Such glitches are annoying to consumers. Dr. Deborah Kubasiak, a Chicago surgeon who replaced her aging Mac with an iMac, grouches about her inability to print: "I thought Apple was coming back and I was going to be part of the wave.... They didn't need this."

Still, the iMac is winning plenty of new fans. Take James Dale Sherry of Walnut Creek, Calif. He put off buying a PC for years. After seeing the iMac early this summer, though, he took the plunge—and bought Apple stock to boot. Now, he's a happy customer and a happy investor: Apple's stock stands at around \$37, up from \$14 last December. "I've

made a few hundred dollars," says Sherry. "I think it's cuter now than it was when I bought it." Greater flattery a computer cannot hope for.

By Peter Burrows in San Mateo, Calif., with bureau reports





Someone's not happy.

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WASHINGTON

NO EXIT FROM WASHINGTON



Treasury Secretary Rubin is the most prominent of those who can't leave without seeming to abandon Clinton

For months, a weary Treasury Secretary Robert E. Rubin has been wistfully eyeing the exits, according to friends. But he can't find the right time to bolt. The worsening global financial crisis already has forced Rubin to extend his stay. Now, the President's sex scandal makes it impossible to leave without looking as if he's abandoning a sinking ship—a move sure to rattle the markets. "Bob Rubin is trapped," says David J. Rothkopf, a former top Commerce Dept. official. "He'd love to get out, but his departure now would be worse than Monica Lewinsky discovering another dress in her closet."

The Treasury chief isn't the only top Administration official strapped to a deck chair on the listing USS Clinton. White House officials say other Cabinet officers and Presidential advisers are pondering an exodus after the Nov. 3 election. Insiders say they include Environmental Protection Agency Administrator Carol M. Browner and possibly Health & Human Services Secretary Donna E. Shalala, who rebuked Clinton for his moral lapses. But with impeachment talk rife in Congress, "people will be more likely to stay," says a Clintonite.

That's just as well, because top talent will steer clear of a crippled Presidency. Says Rutgers University Presidential scholar Ross K. Baker: "It's hard enough to get good people toward the end of a viable Presidency." One example: Clinton's inability to recruit a big name to represent him in any impeachment proceedings.

Non-political posts are proving hard to fill as well. Presidential aides say the scandal has hampered efforts to find someone for the Federal Reserve Board, which has had a vacancy for three months. "It's scared off potential nominees," says an official. "People are apprehensive about going through an ugly confirmation battle. Suddenly, a career as a bank senior vice-president doesn't look so bad."

The personnel problem—and the low morale among trapped Clintonites—will make it even harder for a besieged President to craft policies acceptable to a hostile Congress. Certainly, it will be tough for senior advisers to keep their mind on policy when they have one foot out the door. Rubin and Shalala, for instance, would play key roles in Social Security reform next year.

TIED DOWN "[Rubin's] departure now would be worse than Monica Lewinsky discovering another dress in her closet"

What's more, many top Clintonites are ambivalent about serving a President who deceived them when he denied having sex with Lewinsky. "Rubin is not a Clinton loyalist," says one associate. "He likes the President but thinks he screwed up big time." Still, this source predicts Rubin will stay a while longer. "He's a Democratic loyalist and isn't going to burn the party now."

Even if the President can convince heavyweights to become nominees, he'll face confirmation hurdles in the Senate. Republicans say Clinton's woes give the

GOP less incentive to work out dispute over appointments. One casualty may be veteran diplomat Richard C. Holbrooke. His nomination as U.N. ambassador has been snagged over questions about omissions from his financial disclosure report and allegedly illegal contacts with the State Dept.

DROPPING HINTS. Among the few top hands who have signaled they will leave are Chief of Staff Erskine B. Bowles and top political strategist Rahm Emanuel. Presidential press secretary Michael I. McCurry has already announced his departure. It's easier for White House staffers to split because their replacements don't need Senate confirmation and few White House aides have the public stature of Cabinet heads. The exception is Bowles, who could be succeeded by his deputy, John D. Podesta (page 55).

But even Bowles' departure won't move the market the way a Rubin resignation might. "Right now, the market is counting on Bob Rubin and Alan Greenspan staying where they are," says economist L. Douglas Lee, who does political analysis for HSBC Securities.

Rubin isn't discussing his plans. But he has been paving the way for Lawrence H. Summers, his deputy, to succeed him. Summers' confirmation, however, is anything but certain. A veteran House Democrat fears the markets "may want someone with more stature." That's why Rubin and his Cabinet colleagues may be on a longer voyage than they want. And it's not exactly a pleasure cruise.

By Owen Ullmann in Washington



Al Sussman
V.P. Information Technology
Rollerblade Inc.

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says Sussman, "But most of all it helps us react quickly to every move the customer makes. And in this business, that's the only way you can play."

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MARKETING

THE PALL
OVER TOYLAND

Scarce hits and precocious kids could make this a dismal year

Paul Cleveland is no babe in the woods. Still, the former head of the Mattel boys' toy division, who now runs WPF Inc., expected hefty orders for his company's Alien Anatomy game—especially after Toys 'R' Us Inc. ordered 15,000 in 1997. At February's Toy Fair, a Toys 'R' Us buyer stopped by to praise the aliens, which feature removable innards. But praise turned out to be all Cleveland got. "Two years ago they would have doubled their orders," claims Cleveland, who has resorted to selling his aliens in car-wash gift shops. "We have had to scramble."

That goes for the entire toy business. Following the lead of Toys 'R' Us, retailers are cutting back on the number of toys they order. Retail sales for toys are up just 0.7% over last year, according to NPD Group Inc., a Port Washington (N.Y.) marketing consulting group. There isn't likely to be much merry-making in toyland this Christmas, either: NPD projects a 2% hike in overall 1998 sales. "It is a wakeup call for the industry," says Stephen Berman, president of Jakks Pacific, a Malibu, Calif., toymaker. **NOT COOL.** Toys 'R' Us is by far the biggest grinch. Locked in a losing battle for market share with Wal-Mart Stores Inc. and other mass retailers, the company on Sept. 16 announced a restructuring that will close 90 stores, reformat current ones to add kids' apparel and electronics items such as cell phones, and cut prices on existing toy stock. The move comes after a March decision to slash inventory by \$500 million over the next two years. These steps have already hurt shipments and could siphon sales away from newer toys. Toys 'R' Us declined to comment. But the company scheduled a meeting with manufacturers on Sept. 24 to outline how its changes will affect them.

For toymakers such as Mattel Inc. and Hasbro Inc., though, the challenges don't end with Toys 'R' Us. Manufactur-

not enough to drive people into the stores," says John Taylor, an analyst at Arcadia Research.

The boys' aisles are particularly depressing. Action figures tied to Hollywood films and TV shows have long been the cash cows of that side of the business. But the action-hero business is down 15% year to date, according to NPD. "My worry is consumers are more sophisticated—that it isn't cool any more to see a movie and then run

out and buy toys,"

says Woody

Browne

president of

Building Q, a licensing agent.

Worse yet, toy companies are picking up a dangerous signal: They fear that kids are junking their toys sooner these days, putting aside Barbie in favor of Spice Girl CDs, clothes, and video games. "Kids' interest in traditional toys is peaking one or two years earlier than 10 years ago," says John Eyley, CEO of F. A. O. Schwarz.

AVON CALLING. Mattel and Hasbro are trying to head off the defections. Both companies have built sizable collector businesses from scratch in the past few years. Hasbro has diversified into candy. And Mattel is aggressively looking for new sales outlets. Avon ladies now go door-to-door pitching collector Barbie dolls along with their cosmetics, while Shell stations stock Hot Wheels cars.

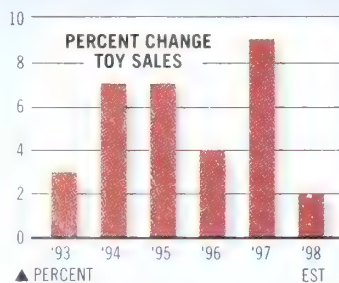
Mattel and Hasbro are going interactive. They already rank among the top 10 PC game makers. Starting in November, kids will be able to design their own Barbies on Mattel's Web site. Hasbro bought Tiger Electronics this year, which now produces most of its board games, including Monopoly and Clue, as CD-ROM or handheld games. "Today we define ourselves as a kids' leisure company, not a toy company," says Adam Klein, head of marketing and strategy.

Of course, nothing will restore faith in the toy industry as much as a megahit. Hasbro and Galoob have bet heavily on toys tied to the upcoming *Star Wars* trilogy. Together, analysts estimate, they could pay almost \$1 billion to George Lucas to license his action figures. After a year of sluggish sales and slashed inventory, the entire toy industry is praying that the Force is with them.

By Kathleen Morris in Los Angeles



A SAD TOY STORY



DATA: TOY MANUFACTURERS OF AMERICA, NPD GROUP

ers simply haven't come up with hot toys yet this year. Hasbro's Teletubbies, Galoob's Spice Girls, and Mattel's Hot Wheels and Winnie the Pooh lines are selling just fine. But they don't compare with last year's rages, such as Tamagotchis. "The couple of bright spots are

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EDITED BY KELLEY HOLLAND

NATIONSBANK'S UNHAPPY MARRIAGE

WHEN NATIONSBANK BOUGHT Montgomery Securities a year ago, many wondered how well hard-charging Chairman Hugh McColl would get along with the investment firm's founder, Thomas Weisel, no shrinking violet himself. The answer came on Sept. 21 when Weisel, 57, resigned as head of what's now NationsBanc Montgomery. Insiders say he was fed up with encroachments by Charlotte (N.C.)-based NationsBank on his San Francisco enclave. The flash point: the bank's recent assumption of control over Montgomery's junk-bond business, which Weisel regarded as its flagship oper-

ation. "Weisel viewed that as a virtual breach of contract," says Joan Zimmerman, an executive recruiter at G. Z. Stephens. Weisel won't comment, but friends speculate he'll launch another firm.

DELL OPENS A DOOR TO THE WEB

ADD DELL COMPUTER TO THE ranks of companies that want to be your Web "portal." On Sept. 23, Dell announced that its small-business and home PCs will come with software to whisk customers to the Net and an Excite site carrying the Dell brand. The offering, called Dell ConnectDirect, will be through a joint venture with Excite and AT&T Worldnet. The new service reflects growing independence from Microsoft—both by joining with Excite, whose portal rivals Microsoft's, and by offering its own browser as well as Internet Explorer, which comes with Win98.

BATTLE SCARS AT BATTLE CREEK

SNAP, CRACKLE, KAPUT. TWO top execs have quit Kellogg as market share and profits sag. Thomas Knowlton, 52, stepped down as North America president on Sept. 21, six days after Donald Fritz, 51, quit as Europe head. Wall Street suspects the new president, Carlos Gutierrez, is wielding the broom. Kellogg says it won't comment on speculation. As price-cutting squeezes margins, market share has slipped to 31% from 35% in 1996. More than 2,000 staff positions are being reviewed.

BAYER BETS BIG ON BIOTECH

GENE SLEUTHS HAVE YET TO produce drugs, but they're having no trouble finding big

HEADLINER: JAMES GOODWIN

THIS IS YOUR NEW CAPTAIN SPEAKING

It isn't every day that labor torpedoes a top exec's chances to take over the corner office. Then again, UAL, which will be 55%-owned by its unions in 2000, isn't your typical company. That's why James Goodwin, 54, is UAL's new president.

Goodwin, a 32-year veteran of United Airlines' parent who rose through the ranks to run UAL's international and then North American operations, was installed on Sept. 22 after President and CEO-in-waiting John Edwardson resigned abruptly on Sept. 18. Edwardson had clashed with the pilots' and me-

chanics' unions over issues ranging from pay hikes to a unionization drive for counter workers.

Union officials seem pleased with Goodwin. "The interaction the pilots have had with him have been quite positive," says pilots' union spokesman

Madison Walton, noting that Goodwin recently helped establish a new system for getting pilots to their hotels more quickly after flights. But company watchers say Goodwin still may not be the next chief executive when CEO Gerald Greenwald is expected to retire in July.

By David Leonhardt



CLOSING BELL

DAMAGED GOODS

Crown Cork & Seal is feeling boxed in by weakening global markets. On Sept. 22, the packaging company's stock plummeted 16%, to 31½, after Crown disclosed that currency weakness in Mexico, Canada, and Brazil, as well as the strong pound in Britain, would hurt earnings. Crown expanded its global reach in 1996 by acquiring a French packaging company. Now it is slamming the brakes on capital spending and will take a \$121 million aftertax charge to close plants and cut head count by 7%.



bucks. In the largest genetics deal yet, Bayer will pay \$465 million over five years for access to genetic data produced by Millennium Pharmaceuticals of Cambridge, Mass. Millennium says it will identify 225 gene-based proteins within five years to help treat cancer, pain, and more. Bayer plans to use new technology to test the value of the drug targets. Both companies say the deal won't produce treatments anytime soon.

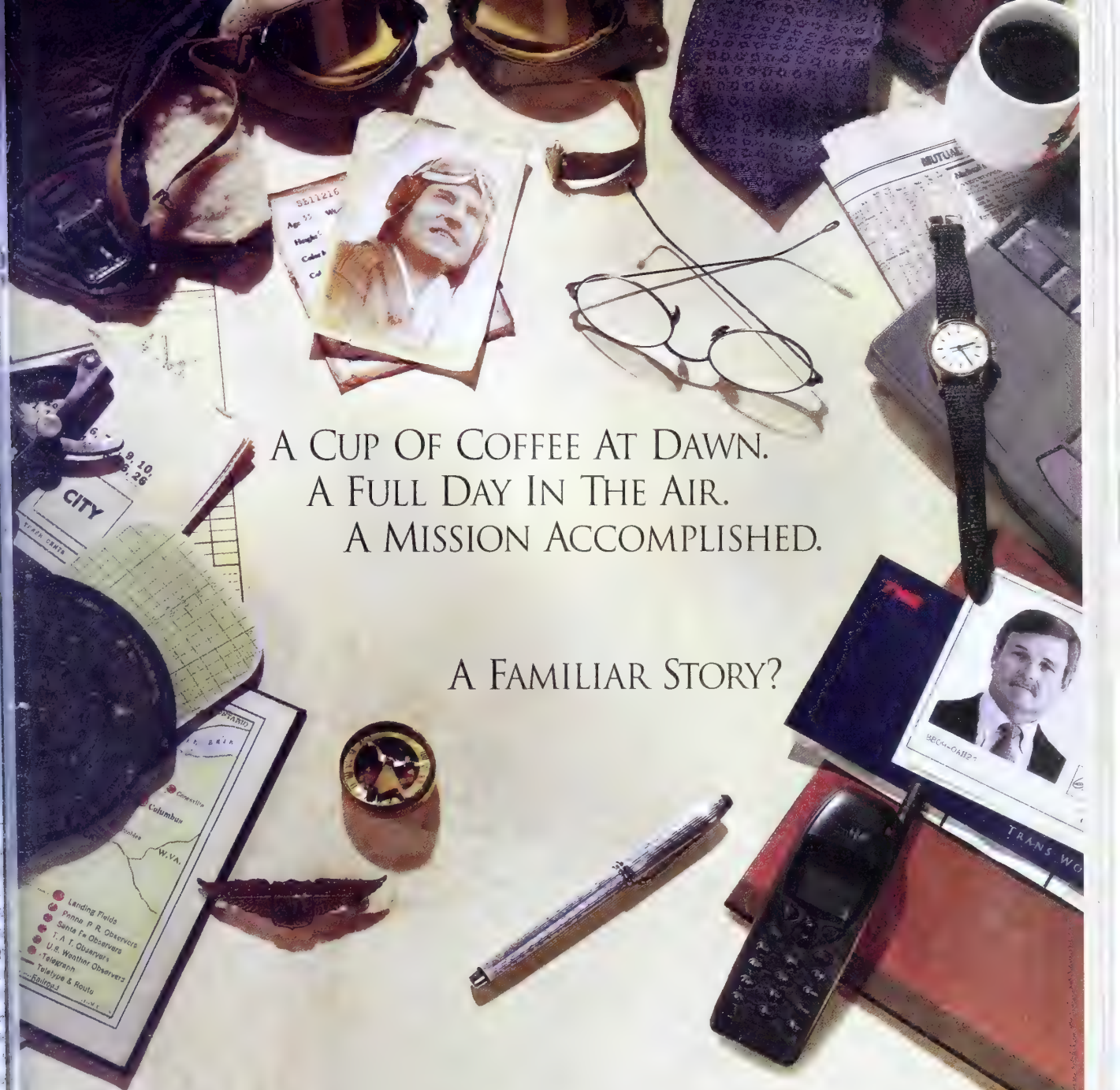
IS GOLDMAN'S IPO ON HOLD?

SO MUCH FOR MARKET TIMING. Goldman Sachs' long-anticipated initial public offering may be delayed because financial stocks are taking a drubbing from the emerging-markets meltdown and a weak IPO market. The firm won't comment. But, says one insider, "the likelihood of

postponement is growing given the uncertainty and volatility in the market. With that may come serious morale problems. The value of partners' and nonpartners' proposed stakes have been reduced to slivers by the market, and employee who had been told what they would get in an IPO may be left with nothing but frustration over how they're valued. "In many respects, they have already destroyed the partnership," says a rival.

ET CETERA...

- Cabletron Systems posted its fourth straight quarter of falling profits, down 75%.
- Polaroid is reshuffling its top management team as its profits plummet.
- America Online will make over a million CD-ROMs weekly of its new AOL 4.0 service.
- The Senate passed bankruptcy overhaul legislation by a vote of 97 to 1.

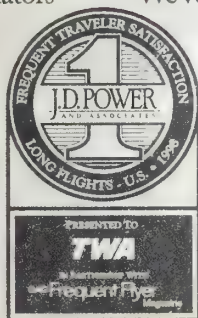


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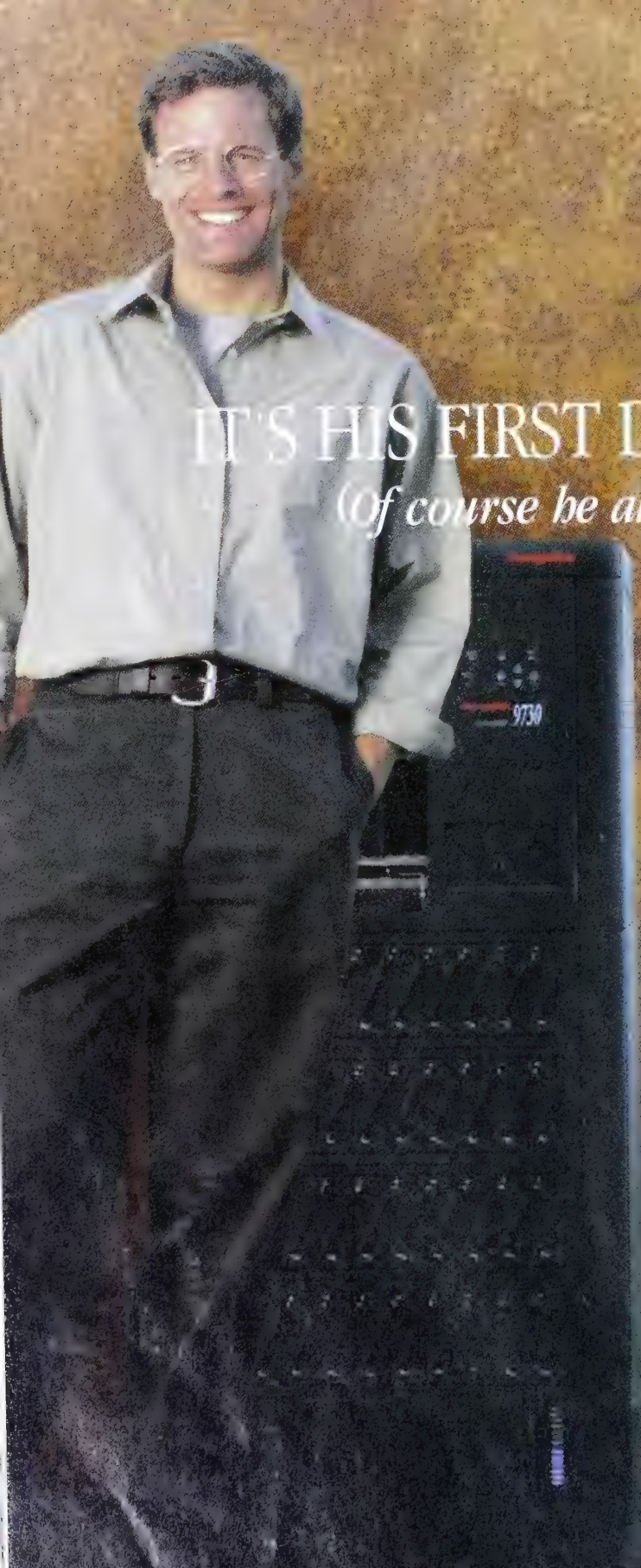
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DITED BY OWEN ULLMANN

CAN THIS MAN SAVE BILL CLINTON'S HIDE?

In a corner of Deputy Chief of Staff John D. Podesta's White House office sits a table piled with kitschy *X-Files* memorabilia. Dubbed "the shrine," it is a testament to his devotion to all things techie, from sci-fi to the arcana of encryption policy.

But these days, Podesta doesn't have much time for Mulder and Scully. A whippet of a man with a nervous laugh, Podesta, who has emerged from the shadows to direct the battle to save the Clinton Presidency. That puts him at center stage in The Rated Files—a drama pitting Clinton against Independent Counsel Kenneth W. Starr. John's in the eye of the storm—like that cesspool," commiserates former Deputy Chief of Staff Harold M. Ickes.

Podesta's job could get a lot tougher fast: He is the leading house candidate to succeed the chief of Staff Erskine B. Bowles, who is heading home to North Carolina soon to weigh a run for governor. Podesta won't speculate about a possible promotion, but his boss is effusive. "He shows how to get things done in Congress. He finishes things. And he makes me laugh," says Bowles.

Podesta's wry sense of humor has made him popular with other Clintonites, too. One associate says one associate: "John can go from being a stitch to being very abrupt, moody, and secretive." Perhaps such funks are understandable, considering his challenge. Though Clinton weathered both the release of Starr's report and the airing of his illicit Aug. 17 grand jury testimony, Democrats still fear the scandal will devastate candidates this fall.

HIT, FIGHT, FIGHT. Podesta is trying to dampen the pessimism. He is blitzing Capitol Hill to give pep talks to panicky Democrats and dangling a deal that could result in a quick change of the President. And he has rushed in reinforcements to bolster ties to the Hill, tapping several former White House lobbyists as volunteer firefighters. "They're trying to make Democrats feel more secure and get them out of town" to hit the campaign trail, explains a lobbyist advising Team Podesta. The idea is to work on a few members who are straying. "They pols cheer Podesta's efforts, but doubts linger. "There's no I'd rather have in a bunker with me," says Democratic consultant Joe Trippi. "The question is, can anyone get out of the bunker alive?"

Ultimately, Podesta's scandal-control strategy rests on

shifting Clinton's defense away from legalistic claims that he didn't commit perjury to the more salable notion that sexual indiscretions don't warrant removal. By harping on the idea that Republicans are engaging in a vendetta, the White House hopes to keep Democratic and independent voters from straying in November.

It may be working. According to a CBS News poll conducted after the grand jury videotape aired, the President's job approval rating soared to 68%, from 59%. Says Democratic consultant Michael Berman: "The hemorrhaging has stopped."

Republicans insist that Clinton's good tidings will be short-lived. And they're irked that a longtime activist such as Podesta could soon be directing defense strategy from the Chief of Staff's office. Hill Republicans view the more conservative Bowles as "an honest broker," says a GOP leadership aide. But Podesta is "a partisan who will fight, fight, fight to the end."

VALLEY GUY. Podesta—a lawyer who has been involved in national politics since 1968 and directed research on opposition candidates for the '88 Dukakis campaign—has strong ties to labor and other liberal groups. As a top staffer for Senators Patrick Leahy (D-Vt.) and Thomas A. Daschle (D-S.D.), now Minority Leader, Podesta often butted heads with Republicans. "He always was the most knowledgeable person in the room," recalls Leahy. Adds Daschle: "John has one of the best networks in town."

But Podesta isn't just a liberal caricature. On the Hill, he became fascinated with technology and is now well-versed on data encryption and privacy issues. His heart may be with labor and environmentalists, but his head is in the Information Age. "Podesta is one of the few people in the White House attuned to Silicon Valley," says Dan Schnur, a GOP technology consultant in California.

Republican stalwarts dismiss Podesta as a second-stringer who isn't up to the job of leading Clinton's survival fight. But those who have watched his steady climb say it's risky to underestimate him. "John will never have the buddy-buddy relationship with the President that Erskine has," says a friend. "But maybe that's not what Clinton needs right now. Maybe he just needs a lawyer with political smarts." And a touch of *X-Files* paranoia, too.

By Lee Walczak and Richard S. Dunham



Podesta, chief of scandal control, may soon succeed Bowles as chief of staff

MUTUAL FUNDS: THE BEARS HAVE IT

Last quarter's double-digit gains belonged only to those who bet on market declines

Aarugh! That about sums up the third-quarter performance—or lack thereof—for equity mutual funds. Or for most funds of any kind. With U.S. diversified equity funds plunging an average of 14.8%, vs. the 9.5% tumble of the Standard & Poor's 500-stock index, U.S. diversified equity funds are on track to rack up their fifth year of underperformance against the broad index. Among equity funds, not one category tracked by Morningstar Inc. managed to eke out a positive return as of Sept. 21. To get even more of a feel for how depressing a quarter it was, consider this underwhelming victory: The very best-performing equity fund group, utilities, sported a -4.2% total return. "It was the quarter that

put the fear of God back into investors," says Kurt Brouwer of investment advisory firm Brouwer & Janachowski. "It reminded people that risk exists."

The few funds that managed to achieve double-digit gains were, not surprisingly, designed to profit from a bear market. After being down 6% for the quarter before July 17, when the stock market peaked, Prudent Bear fund manager David Tice has since seen his fund roar back, racking up an 18.4% gain for the quarter. Tice and other bearish fund managers have waited a long time for such a triumph. Says Charles L. Minter, portfolio manager of two other bear funds, Comstock Partners Capital Value A fund, which gained 14.8%, and Comstock Partners Strategy O, up 11.5%:

"A lot of people would have thrown in the towel by now, but we haven't, and we think history will prove us right." Minter's tenacity has been costly: At the end of 1990, the Comstock Partners Strategy O Fund had \$1.2 billion in assets. It now has about \$90 million.

"RISK DIDN'T PAY." The bears managed to snag 6 of the top 10 slots among the best-performing mutual funds for the quarter and garnered virtually all of the double-digit returns. ProFund Advisors LLC's \$49 million UltraBear Pro Fund, which seeks to produce a return of twice the inverse of the S&P—to be up, say, 10% on a day when the S&P is down 5%—saw its strategy rack up a 17.4% gain, hitting its target. The fund has 90% of its assets in money-marke

THE BEST RETURNS

	TOTAL RETURN*		TOTAL RETURN*
PRUDENT BEAR	18.44%	STRONG AMERICAN UTILITIES	0.58%
ULTRABEAR PROFUND	17.38	FLAGSHIP UTILITY INCOME A	0.40
COMSTOCK PARTNERS CAPITAL VALUE A	14.84	FIDELITY SELECT HEALTH CARE	0.31
COMSTOCK PARTNERS STRATEGY O	11.46	VANGUARD LIFESTRATEGY INCOME	0.31
POTOMAC U.S./SHORT	10.49	MATHERS	0.31
RYDEX Ursa	10.45	VANGUARD/WELLESLEY INCOME	0.27
INVESCO GROWTH & INCOME	6.60	KEMPER RETIREMENT VII	-0.19
FIDELITY SELECT COMPUTERS	5.82	RYDEX OTC	-0.23
LEXINGTON STRATEGIC INVESTMENTS	5.56	FIDELITY SELECT UTILITIES GROWTH	-0.24
SMITH BARNEY TELECOMM INCOME	4.06	FIDELITY FREEDOM INCOME	-0.36
SMITH BARNEY INTERNATIONAL BALANCED A	3.93	STAGECOACH LIFEPATH OPPORTUNITY A	-0.46
LINDNER BULWARK INV	3.01	FIDELITY ASSET MANAGER: INCOME	-0.47
EATON VANCE GREATER INDIA B	2.63	AMERICAN CENTURY UTILITIES	-0.57
BARR ROSENBERG MARKET NEUTRAL INV.	2.30	INVESCO STRATEGIC HEALTH SCIENCES	-0.62
RIGHTTIME MIDCAP	2.24	CLIPPER	-0.63
FRANKLIN UTILITIES I	2.23	CALAMOS STRATEGIC INCOME A	-0.74
MERRILL LYNCH UTILITY INCOME B	1.83	AMERICA'S UTILITY	-0.90
PRINCIPAL UTILITIES A	1.65	RYDEX TECHNOLOGY ADV.	-0.90
GALAXY II UTILITY INDEX RET.	1.52	MORGAN STANLEY DEAN WITTER UTILITIES B	-0.99
APEX MID CAP GROWTH	1.20	AMERICAN CAPITAL EXCHANGE	-1.00
COUNTRYWIDE UTILITY A	1.08	PUTNAM UTILITIES GROWTH & INCOME A	-1.02
VANGUARD SPECIALIZED UTILITIES INCOME	1.03	KEMPER RETIREMENT VI	-1.05
LEUTHOLD CORE INVESTMENT	0.94	FEDERATED UTILITY A	-1.12
RIGHTTIME BLUE CHIP	0.86	COPLEY	-1.14
RIGHTTIME SOCIAL AWARENESS	0.60	CONCORDE INCOME	-1.18

The bears enjoyed a long-awaited triumph, grabbing the top six slots

THROUGH SEPT. 21, 1998

instruments and 10% in exchange-traded futures and options contracts that are bets on a declining market. ProFund, geared toward investors who want to profit from short-term movements in the market, allows shareholders unlimited switching among a family that includes the Bear, Ultra otc, Ultra-Bull, and Bull ProFund. Right now, ProFund has a lot of people on the sidelines, with \$60 million in the firm's money market funds.

Equity funds taking a more balanced approach avoided much of the downdraft. Of the top 50 performers, 14 were income-oriented utility funds, which shone in a falling-rate environment. A number of "lifestyle" funds, which invest in a mix of stocks, bonds, and cash, also showed up in the top 50. While their returns won't enhance anyone's lifestyle—the five such funds on the list of winners were down an average of 0.35%—they won't crimp it either, and in the third quarter, that was something to be thankful for. Says John Lekenthaler, director of research at Morningstar: "It's the worst quarter for stock funds, across the board, since the third quarter of 1990."

The carnage caused many investors to flee from risky securities and seek safety. "The big theme for the quarter is that risk didn't pay," notes Reken-

HOW THE BIG FUNDS FARED

FUND	NET ASSETS BILLIONS	TOTAL RETURN*
FIDELITY MAGELLAN	\$62.3	-10.18%
VANGUARD INDEX 500	55.5	-9.38
WASHINGTON MUTUAL INVESTORS	46.7	-6.89
INVESTMENT COMPANY OF AMERICA	45.2	-6.77
FIDELITY GROWTH & INCOME	38	-8.11
VANGUARD/WINDSOR II	30.1	-11.51
FIDELITY CONTRAFUND	30.1	-9.06
VANGUARD/WELLINGTON	24.5	-4.58
AM. CENT-20TH CENT. ULTRA INV.	22.7	-11.82
FIDELITY PURITAN	22.4	-6.66

* APPRECIATION PLUS REINVESTMENT OF DIVIDENDS AND CAPITAL GAINS BEFORE TAXES.
JULY 1 THROUGH SEPT. 21, 1998

DATA: MORNINGSTAR INC.

thaler. "Really high-risk securities like emerging-market and high-yield debt, or small-cap stocks, got annihilated. Medium-risk securities, such as better-quality blue-chip stocks, just got whipped." The exception to the trend: high-quality securities such as Treasuries. Indeed, the highest return came from long-term government funds, which rose 4.9%.

Other investors sought shelter in traditional defensive issues, such as utilities or precious metals. That helped investors beat the S&P's 9.5% loss. But are losses of 4.2% and 7.8%, respective-

ly, much to cheer about? Another diversification play, supposedly with a defensive bent, would be real estate funds. But they underperformed the S&P and were about even with the decline in the average U.S. diversified equity fund, losing 14.3%.

HAMMERED. Size didn't matter this quarter, as large-cap, mid-cap, and small-cap funds posted average losses topping 10%. Losses were large among the industry's biggest mutual funds (table), too, though 7 of the 10 largest funds did manage to have smaller losses than the S&P. Fidelity Magellan is still the largest fund, at \$62.3 billion, but it lost 10.2%. The best-performing megafunds: Vanguard/Wellington, which had a 4.6% loss, and Fidelity

Puritan, down 6.7%. Throughout the long bull market, these funds tended to trail their bigger, more equity-oriented brethren, since they are hybrids and invest in bonds. But in this environment, their bond holdings helped limit the damage.

Bond funds were hammered far less than equity funds, but even they didn't escape the bloodbath. The average return of 1,285 taxable bond funds tracked by Morningstar: -0.65%. While many bond funds ground out gains of 1% or 2%, a few lower-rated bond groups had major meltdowns. High-yield bond funds

THE WORST RETURNS

	TOTAL RETURN*		TOTAL RETURN*
LEXINGTON TROIKA RUSSIA	-64.11%	RYDEX ENERGY SERVICES INV.	-32.18%
VONTOBEL EASTERN EUROPEAN EQUITY	-47.37	DREYFUS AGGRESSIVE GROWTH	-32.08
MONTGOMERY LATIN AMERICA R	-41.96	FIRSTAR MICROCAP RET.	-32.03
EXCELSIOR LATIN AMERICA	-40.44	GOLDMAN SACHS SMALL-CAP VALUE A	-32.0
INVESCO LATIN AMERICAN GROWTH	-39.85	T. ROWE PRICE LATIN AMERICA	-31.87
AIM LATIN AMERICA GROWTH A	-37.72	LEGG MASON EMERGING MARKETS PRIM.	-31.65
GOVETT LATIN AMERICA A	-36.6	FREMONT EMERGING MARKETS	-31.39
ABN AMRO LATIN AMER. EQUITY COMM.	-35.35	VICTORY SPECIAL GROWTH	-31.27
IAI VALUE	-35.28	CORBIN SMALL-CAP VALUE	-30.9
SMITH BARNEY EMERGING MARKETS B	-34.24	LINDNER INTERNATIONAL INV.	-30.88
SAFECO SMALL CO. STOCK NO LOAD	-34.21	FIDELITY SELECT BROKERAGE & INV.	-30.78
AMERICAN HERITAGE	-34.21	DREYFUS PREMIER AGGR. GROWTH A	-30.7
FEDERATED LATIN AMER. GROWTH A	-33.97	MONTGOMERY SMALL-CAP R	-30.68
FRONTIER EQUITY	-33.76	USAA EMERGING MARKETS	-30.34
BT INVESTMENT LATIN AMER. EQUITY	-33.74	AIM EMERGING MARKETS B	-30.33
IVY SOUTH AMERICA A	-33.72	VAN ECK/CHUBB CAPITAL APPREC.	-30.32
NEWCAP CONTRARIAN	-33.33	GOVETT SMALLER COMPANIES A	-30.29
AMERICAN HERITAGE GROWTH	-33.33	WACHOVIA EMERGING MARKETS A	-30.26
MERRILL LYNCH LATIN AMERICA B	-33.17	NORWEST ADV. SMALL CO. STOCK A	-30.08
CRABBE HUSON SPECIAL PRIM.	-33.11	TEMPLETON LATIN AMERICA I	-30.01
CRABBE HUSON SMALL-CAP PRIM.	-32.85	STATE STREET RESEARCH GLOB. RES. B	-29.74
GINTEL	-32.77	PIONEER EMERGING MARKETS A	-29.68
FIDELITY SELECT ENERGY SERVICE	-32.55	TEXAS CAPITAL VALUE & GROWTH	-29.63
FIDELITY LATIN AMERICA	-32.55	AIM DEVELOPING MARKETS A	-29.52
VAN KAMPEN LATIN AMERICAN A	-32.31	REGENT EASTERN EUROPEAN	-29.38

Russia was the hardest hit, but Latin America funds were close behind

* APPRECIATION PLUS REINVESTMENT OF DIVIDENDS AND CAPITAL GAINS BEFORE TAXES: JULY 1 THROUGH SEPT. 21, 1998
DATA: MORNINGSTAR INC.

slid 8.5%, and emerging-markets bond funds plunged 32.5%. That burned a lot of investors, since up until April about 80% of the money coming into bond funds was in emerging-market debt, according to David C. Masters, senior fund analyst at Standard & Poor's Micropal. Brouwer calls the stampede out of emerging markets a triumph of perception over reality. "Latin America is doing pretty well, but once the dam burst in Russia, everyone started dumping everything," he says. "These countries are priced as though they're going away. There's definitely value in Latin America."

FEELING GOOD. Some bond-fund managers bucked the downward trend. One manager feeling good is David W. Schroeder, who counts three funds he either manages directly or oversees among the quarter's top 10 performers. He had the top-performing bond fund for the quarter: the \$154 million American Century-Benham International Bond Fund, up 9.7%. One big reason for the gain: the flight to quality. The fund focuses on high-quality bonds—bonds rated AA or higher—and 65% of fund assets must be invested in government or agency securities. Schroeder describes the fund as "a fairly diversified, high-quality currency play" aimed at preserving dollar purchasing power when the dollar is falling against G-7 currencies such as the Japanese yen and German mark. Schroeder, whose fund is 80% invested in European currencies, figures about 6.7% of its gain came from its currency play this quarter. Schroeder's other winners are two zero-coupon Treasury bond funds.

While the U.S. equity market caused a lot of investors pain, venturing into

THE BOND-FUND LEADERS

TAXABLE FUNDS

	TOTAL RETURN*
AMER. CENT-BENHAM INTL. BOND	9.68%
GUINNESS FLIGHT GLOBAL GOVT. BOND	9.58
MANAGERS GLOBAL BOND	9.07
VONTOBEL INTERNATIONAL BOND	8.73
STRONG INTERNATIONAL BOND	8.42
DEUTSCHE EUROPEAN BOND B	8.23
NORTHERN INTERNATIONAL FIXED-INCOME	8.07
AMER. CENT-BENHAM TARGET MAT. 2010	7.66
AMER. CENT-BENHAM TARGET MAT. 2025	7.46
RYDEX U.S. GOVERNMENT BOND	7.31
AVERAGE OF 1,285 FUNDS	-0.65

TAX-FREE FUNDS

	TOTAL RETURN*
CALIFORNIA MUNI	3.84%
CALIFORNIA INV. TAX-FREE INCOME	3.35
SECURITY MUNICIPAL A	3.16
NORTHERN CA TAX-EXEMPT	3.15
FIRST INVSTRS. MULTI-ST. INS. T/F CA A	3.11
CGM AMERICAN TAX-FREE	3.10
COLONIAL CA TAX-EXEMPT A	3.07
CITIFUNDS NATIONAL TAX-FREE INC.	3.07
U.S. GLOBAL INVESTORS TAX-FREE	2.99
OPPENHEIMER CA MUNICIPAL A	2.98
AVERAGE OF 1,378 FUNDS	2.04

* APPRECIATION PLUS REINVESTMENT OF DIVIDENDS AND CAPITAL GAINS BEFORE TAXES: JULY 1 THROUGH SEPT. 21, 1998 DATA: MORNINGSTAR INC.

the equity markets of less developed countries proved excruciating. The biggest loser: the \$20 million Lexington Troika Russia Fund, down 64.1%. The best-performing equity market in 1997, Russia has become 1998's worst-performing market because of a political and economic collapse, says Lawrence Kantor, managing director of Lexington Management Corp. Kantor isn't giving up on Russia and is positioning his fund to pounce on a recovery once the uncertainty ends. The fund is now about 30% in Russian oil, telecom, and utility companies that Kantor says have good cash flow, with the balance in U.S. Treasuries.

The turmoil in Russia spilled over into the emerging markets, and the damage there is severe. Latin American equity funds fell more than 33%, and diversified emerging-markets funds fell 26%. Of the 10 worst-performing funds

in the three months ending Sept. 21, seven were focused or heavily invested in Latin America. Sticking to more-developed equity markets didn't help much, with Europe funds falling an average of 19.6%.

So far, despite the market's violent behavior, investors aren't stampeding out of mutual funds. About \$5.4 billion flowed out of funds in August, says Carl Wittnebert, director of research for Trim Tabs Financial Services Inc. But he estimates that equity funds could see a \$20 billion inflow in September, an average monthly rate for 1998. "We think people are now putting money in money-market funds that earlier would have gone in equity funds. People get scared, and wait for the market to stabilize and go up." That may mean steeling themselves for at least a few more quarters of pain.

By Suzanne Woolley in New York

A DISMAL QUARTER FOR EQUITY FUNDS

* APPRECIATION PLUS REINVESTMENT OF DIVIDENDS AND CAPITAL GAINS BEFORE TAXES: JULY 1 THROUGH SEPT. 21, 1998 DATA: MORNINGSTAR INC.

	TOTAL RETURN*		TOTAL RETURN*
UTILITIES	-4.18%	MID-CAP VALUE	-16.72%
INTERNATIONAL HYBRID	-6.14	WORLD	-16.99
DOMESTIC HYBRID	-6.43	MID-CAP GROWTH	-17.02
HEALTH	-6.60	NATURAL RESOURCES	-17.34
PRECIOUS METALS	-7.77	FINANCIAL	-17.68
JAPAN	-8.21	FOREIGN	-17.85
LARGE-CAP GROWTH	-10.76	EUROPE	-19.64
LARGE-CAP BLEND	-10.81	SMALL-CAP VALUE	-20.37
TECHNOLOGY	-10.98	SMALL-CAP BLEND	-22.17
DIVERSIFIED PACIFIC/ASIA	-11.39	SMALL-CAP GROWTH	-22.56
LARGE-CAP VALUE	-11.49	DIVERSIFIED EMERGING MKTS.	-25.97
PACIFIC/ASIA EX-JAPAN	-11.76	LATIN AMERICA	-33.27
COMMUNICATIONS	-13.2	U.S. DIVERSIFIED EQUITY	-14.75
REAL ESTATE	-14.33	ALL EQUITY	-13.99
MID-CAP BLEND	-15.24	S&P 500 INDEX	-9.46
UNALIGNED	-16.37		

Utility, hybrid, health, precious metals, and Japan funds all bested the S&P 500

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BY GENE G. MARCIAL

TWO SUITORS FOR 3COM?

Shares of 3Com (COMS) have been hot lately—in spite of the market slump. From a low of 23 on Aug. 31, the stock of the No. 2 maker of computer-networking equipment has leaped—to 32% on Sept. 22. What's going on?

Investor optimism that an earnings turnaround is at hand is buoying the stock, to be sure. 3Com posted better-than-expected earnings for its first quarter, ended Aug.

SOMEBODY IS BUYING LATELY



3COM STOCK PRICE WEEKLY CLOSE

▲ DOLLARS

28, following solid fiscal fourth-quarter results. The stock is worth 37 to 40 a share based on its earnings growth alone, figures money manager Tom Galvin at Forstmann-Leff Associates, a New York investment firm. But bulls are buying for another reason: There is speculation 3Com may soon be acquired. For some weeks, rumors have swirled that both chipmaker Intel and telecom-gear giant Lucent Technologies are interested in 3Com, which produces modems, remote-access products, adapters, hubs, and switches for Ethernet and other high-speed networks. A New York hedge-fund manager who is accumulating 3Com thinks that either Intel or Lucent will acquire 3Com this year—and then will sell the parts it doesn't need.

He figures that 3Com, with a current market cap of \$11 billion, is worth 50 a share, or \$17.8 billion, in a buy-out. This pro notes that Intel is on the prowl for an acquisition to get a bigger share of the PC market, possibly by providing devices that would enable users to do computer networking at home. To do that, he says, Intel needs to increase its role in network adapters, or network interface cards that allow desktop computers to connect to local area networks. Some analysts argue, however, that Intel may face antitrust issues if it goes after 3Com. That hasn't stopped certain hedge funds from buying 3Com

shares on the prospects of a takeover.

3Com is the world's top supplier of Ethernet adapters, with 59% of the market for fast-Ethernet adapters. 3Com and Intel have been "battling in a price war to gain share in this segment," notes Aydin Tuncer, an analyst at Standard & Poor's.

Lucent is also said to be looking for an acquisition to help it compete with rival Cisco Systems, the dominant router supplier, in the enterprise, or corporate and small-business, market.

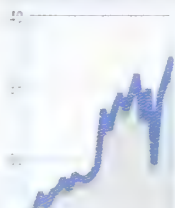
"Lucent needs 3Com's line to fill the gap in its enterprise networking," says the New York investment manager. 3Com spokesman Bob Ingols said the company's strategy is to grow its markets, and it isn't looking to be acquired. "We do a lot of business with both Intel and Lucent," he adds. Lucent spokesman Jeff Baum and Intel's Robert Manetta said they don't comment on takeover rumors as a matter of policy.

XOMED GETS A WHIFF OF GROWTH

Ear, nose, and throat. These are powering the upward drive of Xomed Surgical Products (XOMD), a little-known company whose stock zoomed from 26 a share in late March to nearly 38 on Sept. 22. The reason: Xomed is a pure play in the niche field of surgical tools for disorders affecting these parts of the head and neck.

Despite the stock's huge rise, "Xomed is still very much undervalued," argues

COMING TO A HEAD



XOMED SURGICAL STOCK PRICE WEEKLY CLOSE

▲ DOLLARS

Sam Navarro at ING Baring Furrman Selz, an investment firm. Xomed should hit 52 in a year or 18 months, he says. Earnings of Xomed, which makes powered tissue-removal systems and other microendoscopy instruments—have been growing 25% a year. That rate should quicken to 35% over the next two years, says Navarro. He forecasts earnings of \$1.11 a share for 1998 and \$1.41 in 1999, vs. 1997's 82¢.

Navarro thinks demand for Xomed's devices is being spurred by increased treatment (including cosmetic surgery)

for head and neck problems, sinus and nasal ailments, chronic snoring and sleep disorders, and ear disorders.

Treatments are "evolving with new minimally invasive techniques never before provided," notes Navarro. He expects that Xomed will form partnerships with some drugmakers. Recently, Xomed signed a pact with Sofamore Danek for world marketing.

CHECKING THE FALL AT IVI CHECKMATE

This year's slide at IVI Checkmate (CMIV) is just one example of small-cap stocks that have been battered. From nearly 7 in June, shares of this provider of electronic payments slumped to 4% by Sept. 22. Obviously, a massive rush for the exits took place. But not everyone has given up.

Some believe IVI Checkmate will be a winner—thanks in part to interest from Ingenico. This French company owns 9% of IVI Checkmate, with the right to raise its stake to 15%. Some think Ingenico will add to its holdings—maybe beyond 15%. Chairman Jean-Jacques Poutrel says Ingenico intends to make a "very important" acquisition to boost Ingenico's "position in several countries."

Some investors think IVI Checkmate is the target. IVI Checkmate CEO Barry Thomson acted swiftly to put a poison pill in place. Meanwhile, France's Groupe Bull is said to be poised to buy a stake in Ingenico.

Steve Shook of investment firm Interstate/Johnson Lane in Charlotte, N.C., has put out a strong buy rating on IVI Checkmate, which was formed in June, when Checkmate Electronics and Canada's International Verifact merged. Its products include point-of-sale check readers, signature-capturing devices, and electronic processing equipment. Shook's target for the stock: 11 a share.

A MASSIVE RUSH FOR THE EXITS

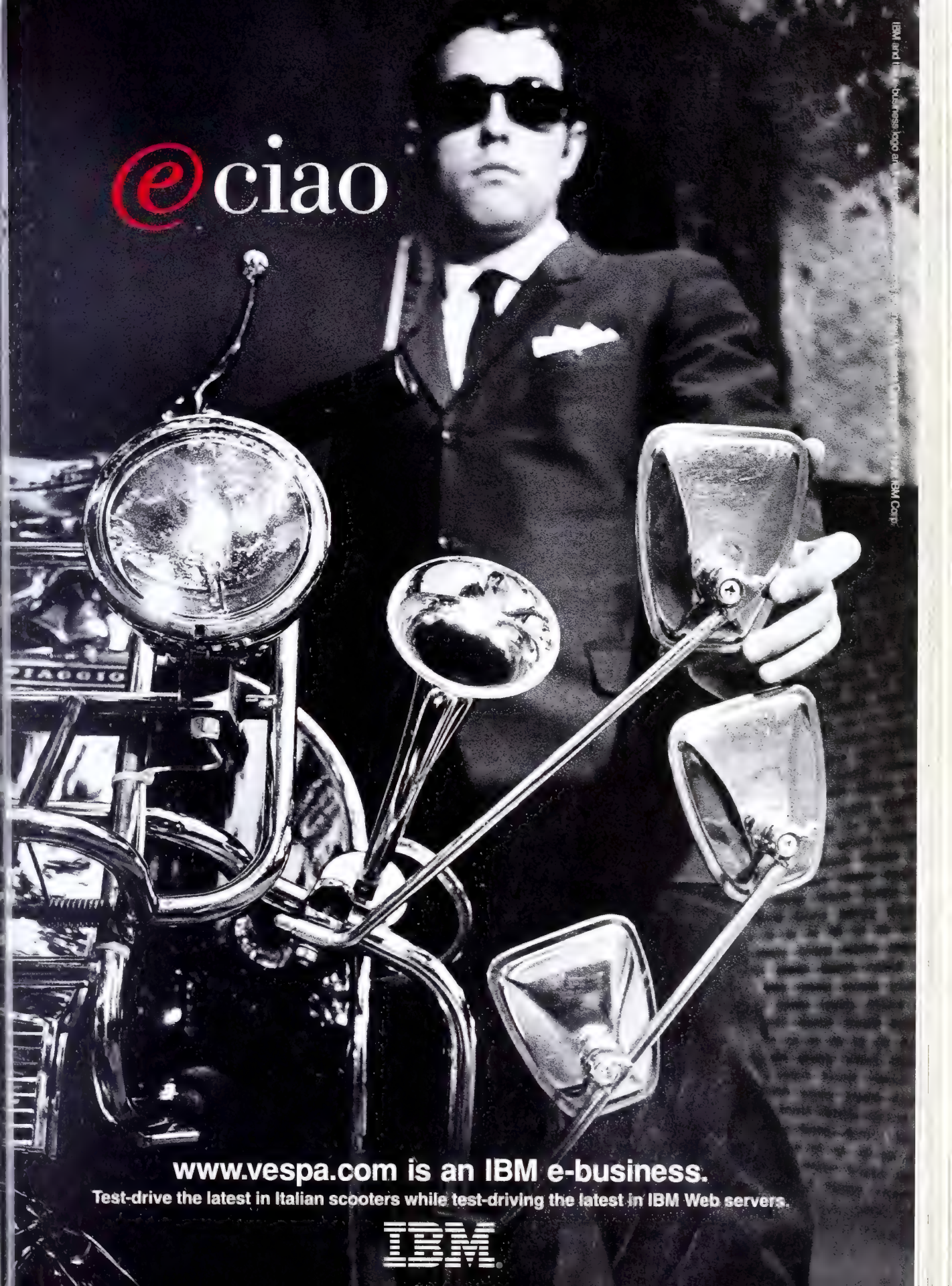


IVI CHECKMATE STOCK PRICE WEEKLY CLOSE

▲ DOLLARS

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A black and white photograph of a man in a dark suit, white shirt, and dark tie, wearing dark sunglasses. He is standing behind a Vespa scooter, which is partially visible in the foreground. The scooter has a large round headlight on the left and several smaller, rectangular side mirrors on the right. The man's right hand is resting on one of the side mirrors. The background is dark and out of focus.

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IN MALAYSIA, ANWAR'S CALLS TO SEVER TIES BETWEEN GOVERNMENT AND BUSINESS HAVE WIDE SUPPORT



ASIA

THE MAIN OBSTACLE TO RECOVERY? POLITICIANS

More than a year into the economic crisis, Asia's leaders are still running away from painful choices

It was certainly juicy stuff. There at a press conference on Sept. 22 was Malaysian Prime Minister Mahathir Mohamad, explaining why he had ordered hooded policemen to burst into the home of Anwar Ibrahim, his former deputy prime minister, and drag him off to prison. Anwar was arrested, Mahathir explained, because he was a vicious sodomite, a menace to public morals. He even offered lurid details of Anwar's sex life.

Anwar was a menace all right—a menace to politics as usual. He had made noises advocating economic reform that

ran straight into opposition from Mahathir, who has long kept close ties between corporate Malaysia, the banks, and the government. Mahathir sacked Anwar in part because he called for changes to that cozy relationship. Then, in the days before his imprisonment, tens of thousands of people poured into the streets of Kuala Lumpur to express their support for Anwar and his message. But the police did their work well, and the crowds scattered.

Those crowds may march again to demand reform. Or, deprived of Anwar, the opposition may end up retreating in confusion. Either way, the recent events in Malaysia and elsewhere underscore a scary truth: Throughout the region, politics is fast becoming the chief obstacle to economic recovery. When the crisis began knocking down Asia's economies back in July, 1997, the hope

was that the hardships would cause a fundamental overhaul of the system. Sheer necessity would drive change. Gone would be the bad banking practices, the cronyism, and the political favoritism that pushed several Asian countries so deep into debt that they had to go to the International Monetary Fund for help. Transparency, accountability, and profitability would be the rallying cry of the new politics.

More than a year later, politicians throughout the region are choosing to steer clear of painful choices. Many are simply too weak or too closely linked to vested interests to undertake sweeping change. Structural bottlenecks, bureaucratic resistance and labor issues slow even thwart reform. Those who have implemented changes, as in South Korea or Thailand, have little to show for them. "It's hard to see how these people

who are so deeply entwined in creating the problems can turn around and create the solutions," says Marshall Gitter of Bank of America in Hong Kong. Now, the risk is that instead of redefining themselves as leaner Tigers ready to grow again, the Asian countries will remain so mired in the old ways of doing business that reform will founder. Then, the old problems will fester, weakening the foundation of recovery and setting the stage for future disaster.

NOTHLESS. The political malaise manifests in different ways. In Japan, where economic stagnation has become the norm, Prime Minister Keizo Obuchi's ruling Liberal Democratic Party cannot dismantle the old patronage machine (page 10). In South Korea, President Kim Dae-jung runs a weak government that is trying to play politics the old-fashioned way by hitting its opposition with corruption probes rather than setting up strong institutions that can truly combat cronyism. That leaves the conglomerates, or *chaebol*, with the upper hand. As long as this underdeveloped political system continues, the *chaebol* will not have to overhaul themselves," says Jung In, an economics professor at Hong Kong University in Seoul. "Rather, they will try to expand further to increase their influence in the political system."

In Indonesia, President B.J. Habibie's close association with the discredited Suharto has resulted in weak leadership. Privatization program was supposed to introduce real competition to key industries. Instead, local magnates are objecting to the terms of privatization, and hopes for serious sell-offs are fading fast. Reformers had hoped for a serious inquiry into the Suhartos' business empire and prosecution for possible crimes of corruption. But the investigation is likely to have no bite, given that the attorney general has publicly stated he has no reason to doubt Suharto's claim that he had stashed no money abroad.

Sometimes the elect government is pro-reform, but the opposition is strong enough to blunt its best efforts. In Thailand, where the government of Chuan Leekpai has backed a laudable platform, senators who represent real estate interests are intent on blocking the passage of laws that would speed foreclosures. A dead-end can hang onto a

piece of property for five years before a bank can claim it.

Nothing represents the difficulties of reform as well as the effort to fix the banks. The banking sector has long been the cornerstone of the region's crony capitalism. When times were good, Asia's bankers routinely funneled easy money to favored companies with little regard for the creditworthiness of projects. Lots of that money ended up in the pockets of politicians or their followers. Now, the same players are dragging their feet on reform and defying political pressure to clean up their acts.

Thailand announced a bank restructuring plan last month, but none of the banks so far has agreed to it. Stronger banks, like Bangkok Bank and Thai Farmers Bank, figure they can survive without government help. But the smaller ones are teetering. "In this kind of environment, I see nothing but mounting bad assets," says Michael V. Fung, a banking analyst at Bear Stearns Asia Ltd.

South Korea and Malaysia are assuming more control over the banking sector. Both are pushing ahead with mergers in hopes of squeezing out excess banking capacity and nurturing better-run banks. But most analysts say

these are half-hearted gestures. South Korea may reduce its banks from 30 to 15, but there's little sign of change in a banking culture that has produced staggering loan losses. Essentially the banks cannot afford to allow the *chaebol* to fail, or they themselves will incur staggering bad-loan losses. Most analysts estimate that it will cost at least \$70 billion to cover bad loans and recapitalize banks, far more than the \$37 billion pledged by the government last year. "Hopelessly ailing companies have been kept alive," says Korea University finance professor Park Kyung Suh. "Unless you separate bad firms from good ones, the banking-



MAHATHIR

Will his attacks on Anwar and his supporters trigger a backlash like the one that toppled Suharto?

system bailout will be like pouring water into a bottomless jar."

Malaysia's banking system has turned inward. Capital controls have allowed the leadership to lower interest rates more than three percentage points since early September, easing the pain of the country's heavily indebted business groups. In a bid to stimulate growth, the government is also forcing banks to increase their loan portfolios by 8%, which amounts to an estimated \$1.8 billion a month for the rest of the year. The Malaysian government is also pouring money into banks to keep the system afloat. Since creditworthy companies are already hard

to find in Malaysia, the danger rises that "loans will go out to companies that otherwise would not survive," says Andrew Lee, an analyst at HSBC Securities Malaysia in Kuala Lumpur.

As Mahathir lashes out at Anwar and his supporters, many wonder whether the turmoil will trigger a popular backlash similar to the one that toppled Indonesian President Suharto in May. In the short term, Mahathir has the stronger hand. "It won't happen overnight," but the country will eventually move to support Anwar, predicts Marina Yusof, a former member of Parliament and outspoken critic of Mahathir. Certainly, if Mahathir's policies to bolster Malaysia Inc. fail to improve the economy, he will be increasingly vulnerable to attack. In an ominous move for Mahathir, Thomson Bankwatch Inc. cut Malaysia's credit rating to junk.

The irony is that politicians such as Mahathir have legitimate things to say about the punishing effects of global capitalism. He and other Asian leaders have been pointing out for months how hedge funds have been pounding their markets, making recovery vastly more difficult. Mahathir has understandably maintained that the system needs controls to fend off speculative abuses and give Asia time to reorganize. But capital controls without serious reform just prop up the old practices that got Asia into trouble in the first place. And a political solution to the crisis is still a long way off.

By Joyce Barnathan and Mark L. Clifford in Hong Kong, with Jonathan Moore in Kuala Lumpur, Bruce Einhorn in Bangkok, and Moon Ihlwan in Seoul



OBUCHI

In Japan, where stagnation drags on, the Liberal Democrats cannot dismantle the old patronage machine



COMMENTARY

By Brian Bremner and Emily Thornton

BAD BANKS: WHY JAPAN'S POLS ARE PARALYZED

How's this for a nightmare scenario? As the fragile truce between Japan's ruling Liberal Democratic Party and the opposition unravels, all hope of a credible bank rescue disappears. The government of Prime Minister Keizo Obuchi falls. The Nikkei stock index falls several thousand points within weeks. One major Japanese bank after another publicly declares its insolvency. Credit evaporates, and the economy lurches from recession to depression. In a final humiliation, Japanese authorities under intense pressure from the U.S. invite a team of experts from the Bank for International Settlements to come in and sort out the mess.

This is not as outlandish as it might seem. Alicia Ogawa, managing director of Salomon Smith Barney, thinks the Japanese financial crisis is now "so extremely dangerous" that it will take intervention from some international organization to force a resolution. That's because the entrenched interests working against a

healthy shakeout of the banking sector are enormous. Japan still has the financial resources to restructure the banks. But most of its politicians are using all their energy and expertise to hide the dimensions of the problem, not solve it. "This is really a crisis of political leadership," says Yasuhisa Shiozaki, an LDP member of the Diet and key financial adviser on banking reform.

PET PROJECTS. At the heart of Japan's political problem is a deep fear of revealing just how widespread the rot is. If the LDP elders delivered a true accounting of the banking disaster, they might cast the party into the political wilderness for years. After all, the bubble economy came and went on the LDP's watch. And the collusion between the LDP and the banks—which donated \$4 million to the party last year—is probably monumental. If true reform took place, the banks would have to open their books to public scrutiny. Voters would then learn how the

banks channeled hundreds of millions of soft loans to LDP pet projects, and how some of those loans went to sweetheart investment deals for the politicians. Rumors that top LDP cadres benefited from such schemes have long circulated.

The LDP is not the only political force that has an interest in concealing the truth. The Ministry of Finance regulates the banking industry, and it would have plenty to answer for should all the details of the bank scandals come out. One example: MOF auditors sat idly by while Long-Term Credit Bank of Japan (LTCB), now facing possible insolvency, was caught up in a string of scandals, including the collapse of EIE International, the most corrupt, politically connected real estate developer of the bubble years. No one knows how many similar scandals have yet to unfold, and how badly MOF's failures have hurt the economy. "People will want to know, what were the finance inspectors doing?" says Yoshihiko Miyauchi,

"Earth Shakers."



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The Sickest Banks

LONG-TERM CREDIT BANK

Its stock is down some 90% since January. It faces government takeover and possible liquidation. It needs at least \$7 billion to write off dud loans and rebuild reserves.

FUJI BANK

Burdened with \$17 billion in problem loans. But the bank denies persistent rumors of huge derivative losses.

SAKURA BANK

Level of dud loans: \$11 billion. It may be able to raise \$2 billion from members of its *keiretsu*.

NIPPON CREDIT

Owes nine insurance companies some \$1.5 billion and needs to reschedule payment. It will probably have to merge with another bank.

president of leasing giant Orix Corp. MOF alumni also hold senior positions throughout the troubled bank sector.

So it's no surprise that the latest bank-rescue plan has started to come apart. Pressured to come up with something before Prime Minister Obuchi's Sept. 22 visit with President Clinton, the LDP made some key concessions to the opposition bloc led by Naoto Kan, head of the Democratic Party of Japan (DPJ). According to the agreement, MOF would lose its authority over banking regulation, though nobody was sure when. A new collection agency would buy problem loans from lenders. A committee, free of MOF control, would oversee bank bailouts and enforce tougher disclosure rules. The plan also included a framework for putting LTCB under special public ownership. The opposition took that as a sign that the LDP would dismantle a controversial \$100 billion bank-bailout fund set up in February.

BRAIN-DEAD. The backtracking started almost immediately. It became clear over the weekend that the LDP did not want to shut down the \$100 billion fund, which it had set up to rescue the banks on easy terms without forcing them to disclose embarrassing details, sack their bosses, or declare bankruptcy. The banks are depending on this fund for a soft landing, but Kan and the opposition see it as a way to prop up brain-dead institutions with taxpayer money. Instead, Kan wants any public funds to go to the bank's borrowers and depositors, not the banks' managers. To achieve that, he wants any bailout conditioned on banks' adoption of wholesale management changes, tougher lending practices, and full disclosure.

The LDP also seems intent on carrying through the forced merger of LTCB with a healthy, unwilling Sumi-

tomo Bank, a classic MOF ploy to cover up bank disasters. The opposition thinks nationalization would give authorities more clout to clean up LTCB fast or shut it down. "Banks that will fail should be allowed to fail," says Motohisa Ikeda, a DPJ member and bank committee chairman in the lower house of the Diet. The LDP and the opposition say they will try to revise the reform bill. But given their differences, it will be tough.

An immensely popular figure, Kan offers a lively counterpoint to the gray monolith of LDP policy. But it's too bad this raucous debate did not start five years ago. Now, it's hard to see how a long and drawn-out battle



OPPOSING VIEW

Kan wants any public funds given to banks to be conditional on tougher lending practices and full disclosure

between the LDP and the opposition can be avoided. Obuchi may already be planning to blame political turmoil for any failure to pass a bank-bailout plan. "We have to deal with Parliament, and it will [pass] the measures needed to achieve stabilization," he said at a New York press conference.

Many political analysts think that Obuchi's failure to deliver a viable bank plan to Clinton will weaken him even further. If that's true, then the most progressive members of the LDP could bolt for the DPJ and deprive the LDP of a working majority in the lower house. The LDP could then try to form another government. Should that effort fail, a general election would ensue that could result in victory for a Kan-led coalition.

Kan's brinkmanship is helping to expose the shell game being played by the LDP. The risk is that a bitter electoral campaign would paralyze policy and spook the markets. Big Tokyo banks have been all but cut out of international money markets, which are charging the Japanese a premium of up to 70 basis points over benchmark lending rates for any fresh capital. The banks are also under assault at home by the steep declines in the Nikkei and a new batch of loans turning sour because of plummeting corporate profits.

With no political leadership, there's no bank workout. With no bank workout, there's no recovery. "These are tough times," says Honda Motor Co. President Hiroyuki Yoshino, "and if no [bailout] agreement is reached, things could get tougher."

Indeed, if the government can't take the lead on overhauling the banking sector, the markets will—and it won't be pretty. LTCB was pushed to the edge of insolvency by a sudden and sustained sell-off this summer that has driven its stock down 90%, to about 15¢ per share. The stock plunge drove up LTCB's cost of borrowing to unsustainable levels. Other banks could suffer the same fate, given the government's refusal to disclose credible numbers on the banks' balance sheets. If Tokyo came clean about the condition of the banks, then at least investors would have real numbers to work with. That would be a first in Japan. But the politicians running the country cannot bring themselves to do it.

Bremner and Thornton cover the Japanese economy.

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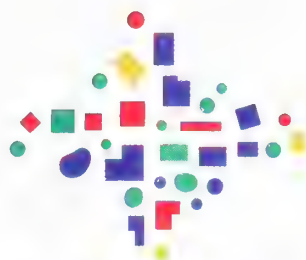
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COMMENTARY

By Ian Katz

BRAZIL DOESN'T NEED A BAILOUT. IT NEEDS LEADERSHIP



Encouraged by pledges of support for Brazil from President Bill Clinton and the Group of Seven, São Paulo's battered stock market soared in mid-September by a near-record 45% in just three days. The rush of dollars out of the country slowed to less than \$400 million per day on average, down from daily outflows of more than \$1 billion earlier in the month. Brokers and analysts chirped optimistically about the easing of Brazil's crisis, touched off by financial tumult in Russia and Asia in late July.

Whoa, there. The line of \$30 billion or more in credits to Latin America that the International Monetary Fund, the G-7 countries, and other international lenders may assemble would be only a reprieve. Brazil, the country at the vortex of Latin America's financial storm, has to take drastic measures—with or without an agreement with the IMF—to curb its runaway deficit spending and its \$276 billion domestic debt. Otherwise, capital flight will resume—and upset the rest of Latin America again.

What Brazilian President Fernando Henrique Cardoso and his advisers clearly hope is that the prospect of multilateral aid to Latin America will calm the turbulence and give Brazil a respite. But with an economy twice

CANDIDATE CARDOSO: *Wide lead, timid steps*

the size of Russia's, Brazil is too big to be bailed out by the IMF or G-7. Brazil must save itself.

The place to begin is at the top. Cardoso, running for reelection Oct. 4, has to start acting less like an insecure candidate and more like a decisive leader. Although he has a wide lead in polls, he delayed boosting interest rates to damp speculation against Brazil's currency. He hiked the rate on Sept. 10 to a draconian 49.75%. Faster action could have slowed the shrinking of reserves to about \$48 billion from \$70 billion in July.

Now, to win back the confidence of the markets, Cardoso needs to push through hefty spending cuts to curb the \$60 billion budget deficit, equal to nearly 8% of gross domestic product. Proposals on Sept. 8 to trim \$3.4 billion from this year's budget disappointed the markets as too timid. And to show that he's committed to tougher measures, he should announce them himself, rather than releasing

the painful news through subordinates.

Cardoso should also have more faith in voters. While the steep interest rates and spending cuts may tip the country into recession, Brazilians trust Cardoso as the leader who ended frightful hyperinflation. "He's the stabilizer," says Ernest W. Brown, Latin America economist for Morgan Stanley Dean Witter in New York. "They're not voting for him because he's the guy who's going to bring growth."

PRICKLY. It's crucial for Cardoso to use the campaign to convince voters of the urgency of slashing bloated public payrolls and revamping the social security and tax systems. These moves have been bogged down in Congress.

Now, after a financial near-panic, is the right time to rally popular pressure on Congress to put the economy on a sound footing. Last fall, it seemed that Cardoso would do just that after a capital flight triggered by Asia's mess. But when money began returning, Cardoso let the agenda slip onto the back burner.

Finally, Cardoso should shed Brazil's prickly nationalistic reluctance to agree to any IMF terms in return for loans. Since the 1980s debt crunch, Brazil has acted coolly toward the IMF, at least in public, believing that posture plays well with voters. But IMF credits and

visible support would further allay devaluation fears. Cardoso has brought Brazil a long way from inflationary chaos, and he is capable of shaping public opinion. With more decisive leadership, a stronger Brazil can emerge from the crisis.

Katz is BUSINESS WEEK's São Paulo bureau chief.

Now is the time to rally popular pressure on Congress to take up a budget-cutting agenda



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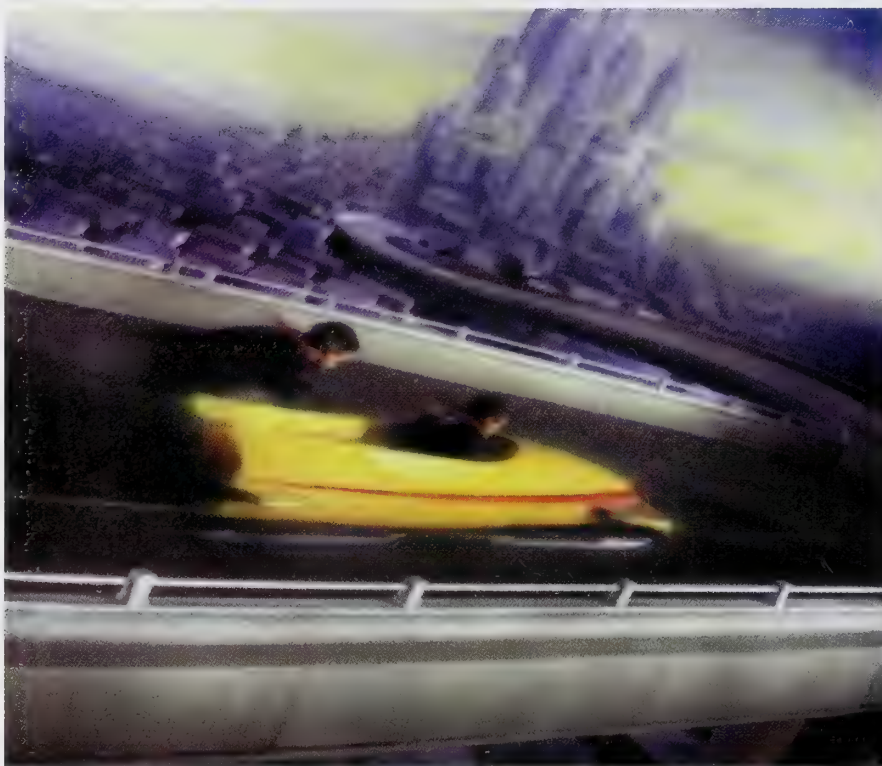
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AUSTRALIA: BUSINESS IS SWEATING THE LABOR PARTY RALLIES

Minister John Howard of Australia may have been using his luck. First, he took a big gamble by calling an early general election for Oct. 3—six months before he was then upped the ante by making a new 10% goods-and-services tax (GST) the centerpiece of his “stronger Australia” campaign. Even so, Australia’s bookies initially made the odds-on favorite to defy political gravity and win.

Now, in the closing weeks of the campaign, Howard’s odds are in the Australian Labor Party are rallying—after a long start. Major polls have given Labor its best chance since March, putting it between one and two percentage points ahead of Howard’s Liberal Party-led coalition. Labor leader Paul Keating has attacked Howard for being “out of touch” with ideas for tackling Australia’s economic problems, which are multiplying: slowing economic growth, contracting exports to Asia, dwindling business investment, and expectations of high unemployment. “His vision [has] no real element, and that’s a goods-and-services tax,” says Beazley.

But the focus on tax policy has pushed other issues into the background. For example, the movement to dump the monarchy as Australia’s head of state, and to make the country a republic, doesn’t feature in the campaign. Nor does Australia’s economic role in Asia. And while the leading parties clash, the populist One Nation Party is gaining the hackles of neighbors by proposing strict controls on immigration—mainly from Asia—and by pushing for protectionist trade policies and big tax cuts. Howard hopes he can regain the high ground. He timed the election to coincide with a peak in the nation’s feel-good mood. Aussie athletes won a record 198 medals at the recent Commonwealth Games in Malaysia. And the final play-offs of the rugby league and Australian-rules football championships will fall around election time. Meanwhile, Howard is

sweetening his GST plan with \$7.7 billion in income-tax cuts.

While his prescription generally pleases business, some executives worry that the promised tax cuts will be a burden on the budget. They also fret that Howard’s achievements in cutting outlays will be frittered away for reasons of political expediency. “Now is not the time to lose the urge for reform,” says Donald R. Argus, CEO of National Australia Bank Ltd.

So far, Howard has had an almost free ride with his reforms. Labor still bears the scars of its massive defeat in 1996. And until recently, that has crimped its opposition to his policies. But the tax issue is getting Labor leaders back in the game.

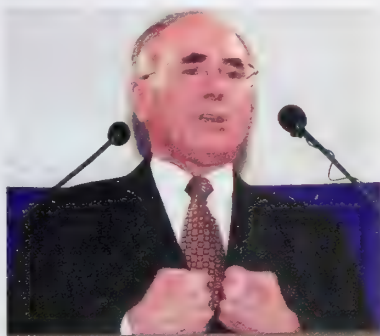
The odds favor them. In the past 20 years, three attempts to introduce a tax on consumption have failed. Polls show that voters remain wary of Howard’s proposal, although they accept a need for tax reform. Labor’s tactic is to rejigger the existing wholesale sales tax and offer tax cuts about half the size of the government package.

A close election without a clear victor could propel Australia into the nightmare of having One Nation hold the balance of power—through its handful of seats. That could weaken the Australian dollar further

and intensify the economic downdraft from Asia. “Any radical view, be it right- or left-wing, is seen as a risk by the markets,” says Christopher Furness, senior market strategist at London consultancy 4CAST.

The traditional parties have tried to ignore One Nation and its leader, Pauline Hanson. The tactic failed in Queensland, the party’s main regional base. And it is allowing Hanson to frame some big national issues. It’s as if mainstream politicians are so overwhelmed by problems that they’ve given up on their biggest challenge—defining Australia’s identity and its place in the world in the 21st century.

By Tracey Aubin in Canberra



HOWARD: Talking a new tax

GLOBAL WRAPUP

A GRABS THE VODKA

With a mountain of economic problems, new Prime Minister Yevgeny Yushchenko is reaching for the vodka—but not to take a swig, as his compatriots do. Instead, he plans to nationalize the industry and reestablish a state-style monopoly over production and sales.

The move could be a hit, even if it would probably raise prices. Thousands of Russians die annually from drinking poor-quality boot-

leg vodka. It may restore to the government some of the estimated \$5 billion a year in lost taxes from illegal production and imports. And the government would gain badly needed access to hard currency from vodka exports.

ISRAEL HAWKS ITS MISSILES

► Successful testing of Israel’s Arrow antiballistic-missile system on Sept. 14 could put it into export orbit. High-ranking defense industry officials say a number of foreign countries are interested in

buying. They include Turkey, which is worried about missile programs in neighboring Iran, Iraq, and Syria, and Japan, over whose territory North Korea recently lobbed a missile.

Israeli sources say they are trying hard to interest the U.S. in using the system to defend American troops in global hot spots. The Arrow’s maker, Israel Aircraft Industries Ltd., could do with a boost. After years of heavy losses, it reported a \$19.7 million net profit on sales of \$929 million in the first half of 1998.

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STAIANO: A SUMMER OF FRUSTRATING SETBACKS

SPACE MOGULS

GETTING IRIDIUM OFF THE GROUND

Ed Staiano is racing to power up a global wireless system

It was a crucial meeting. So, last April, Iridium CEO Edward F. Staiano boarded a 12-hour flight to Beijing despite a terrible cold and sore throat. Once in China, his condition was so bad he could barely speak. Still, Staiano wasn't about to miss his one chance for a powwow with China's powerful Minister of Information Industry, Wu Jichuan. And when Wu offered him an odd-looking Chinese cold remedy, Staiano gamely downed the dark, steaming brew without flinching. The meeting was a success, and Iridium got its coveted Chinese license.

Doing whatever it takes to advance the ball has long been standard operating procedure for the 62-year-old for-

mer Motorola Inc. hotshot. But these days, with the debut of Washington-based Iridium's hugely ambitious global wireless-phone system falling behind schedule and its stock price plummeting by nearly half since May, Staiano is even more driven than usual. Indeed, he has staked his reputation on the monumentally complex system, which relies on 66 satellites, reams of software code, and scores of sensitive agreements with foreign governments.

In recent months, Staiano has been under especially intense pressure as the Sept. 23 deadline, set five years ago, for the system's inception has come and gone. Over the summer, two satellites failed and had to be replaced. Then a

rocket explosion, hurricanes, and even a lightning strike delayed launching the last set of Iridium satellites. Even more troubling, a spate of computer glitches on the ground has postponed offering service until Nov. 1 at the earliest.

Staiano insists he isn't fazed. Known as "Fast Eddie" during his Motorola days, he built the electronic giant's huge cellular-phone business from zip to \$11 billion during a frenzy of growth in the late '80s and '90s. Still, Iridium's \$5.7 billion satellite network is an enormous technological and marketing challenge. If all goes as planned, it will provide a reliable dial tone anywhere on the globe. But, even assuming its numerous technical snags can be worked out, Iridium's \$3,000 handsets and up to \$7-a-minute airtime charges make commercial success far from certain.

NUMBERS GAME. What is certain is that Staiano has been pushing his team of 500 engineers and sales staffers with a ferocity that borders on obsession. At recent board meetings—which consist of 28 telecom executives and investors from around the world—Staiano has taken to egging on members in front of their peers for falling behind schedule, says one executive present at the meetings. At one recent board meeting members were ranked with little green

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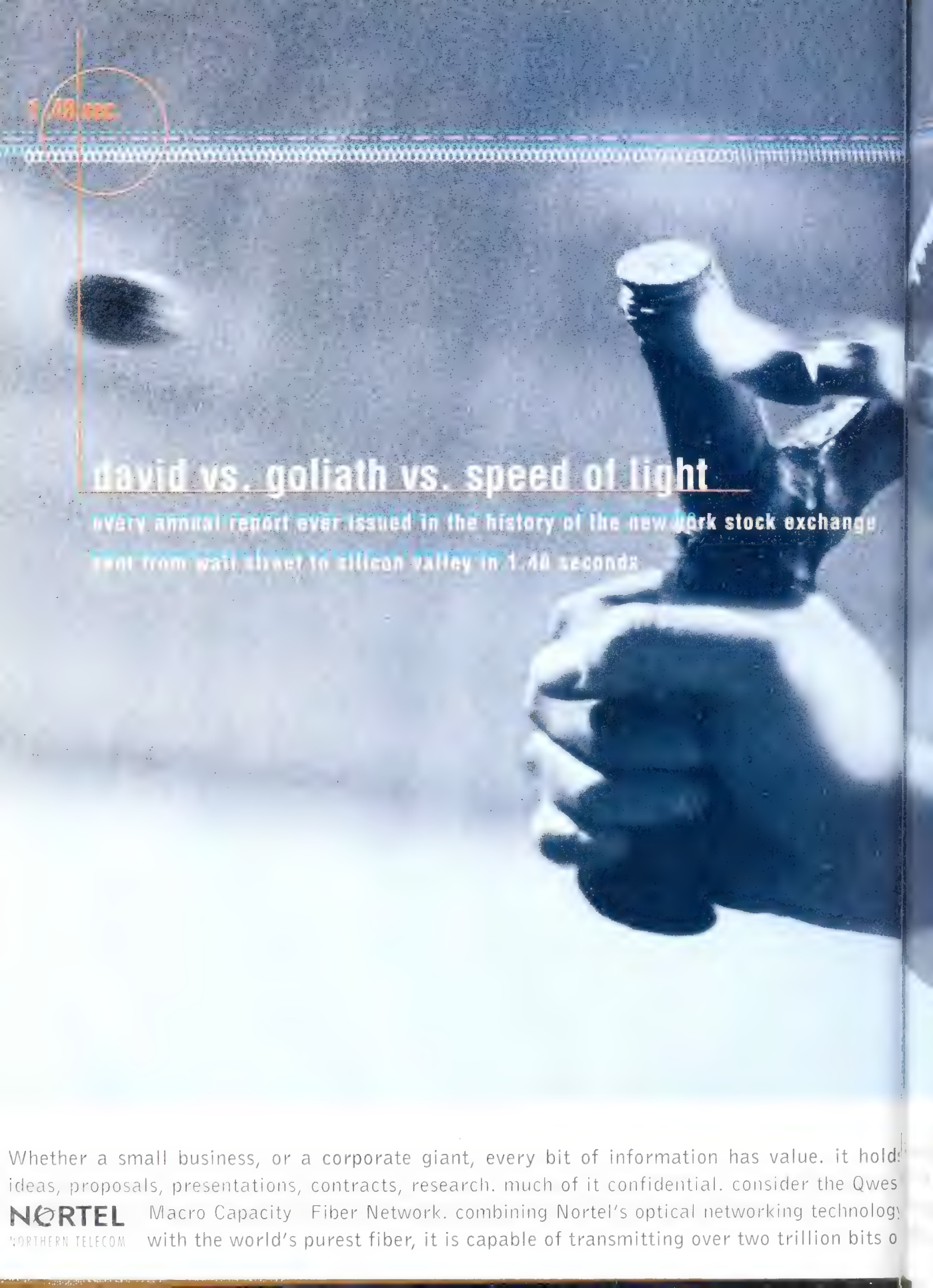
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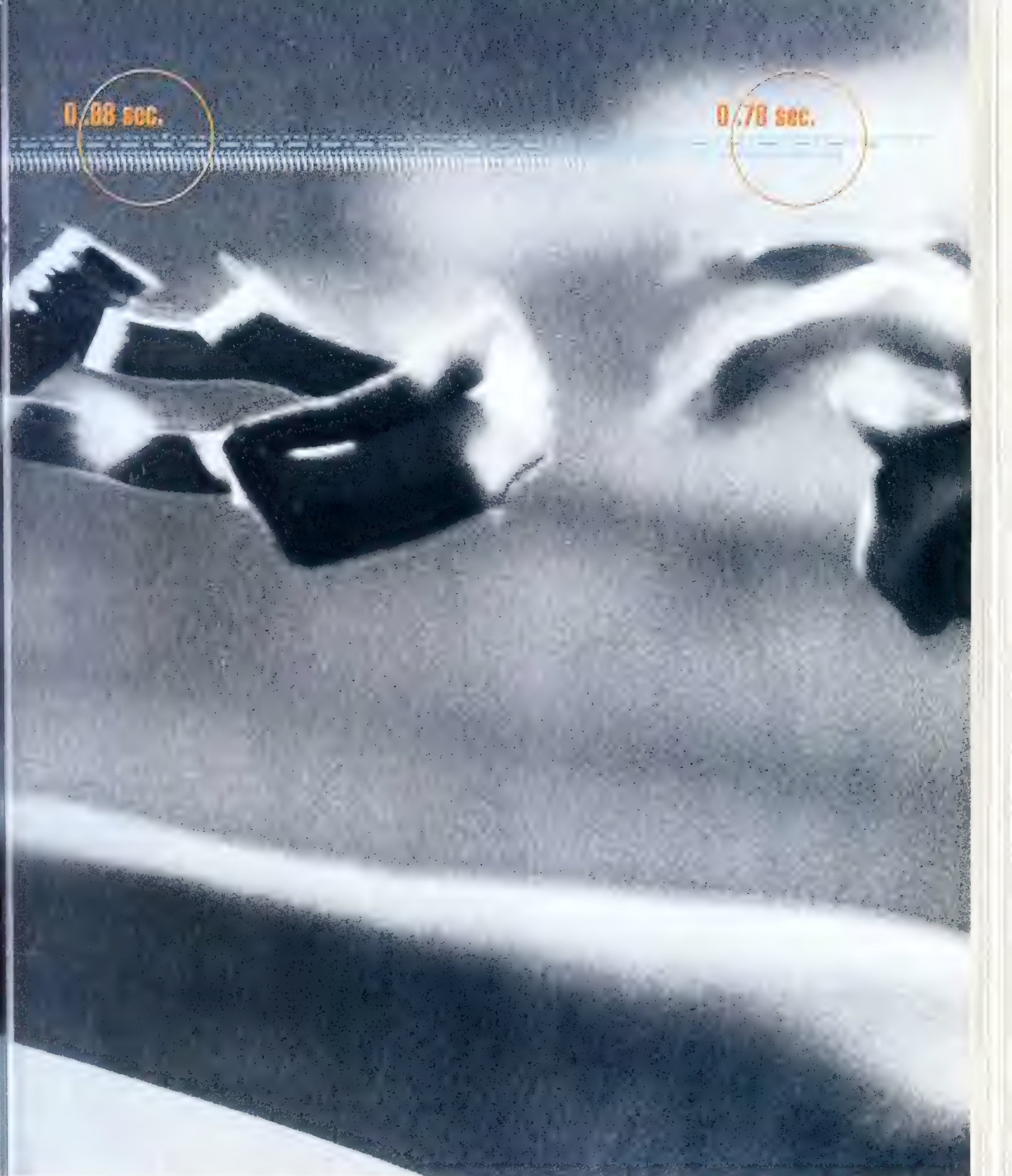


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yellow, or red race cars—green cars for those who were ahead of schedule and yellow and red ones for those who had fallen behind.

If there is one thing Staiano hates, it's being behind schedule. As it became clear Iridium might miss its deadline, he canceled all employee vacations in August and September. But for many staffers, a missed vacation is the least of their worries. Late last year, for instance, Staiano gave Vice-President Craig W. Bond four weeks to identify every wireless-phone number now in use around the globe to ensure that Iridium doesn't assign those numbers to its customers. "We pulled out all the stops to do as much as physically possible," recalls Bond. At the end of four weeks, Bond's team had rounded up 60% of the planet's phone numbers, but Staiano said the results were "totally unacceptable." Says Bond: "He gives absolutely no leeway. He shows no mercy."

Staiano insists he has little choice.

With a \$1 billion bank loan due at the end of the year, and Globalstar Limited Partnership, a Loral Space & Communications Ltd.-backed competitor, set to offer a competing yet more affordable satellite service late next year, Staiano needs paying customers. The Globalstar system, which makes more extensive use of ground networks than Iridium's, cost just \$2.6 billion, and its handsets are likely to retail at a third the price of Iridium sets. Staiano maintains Iridium's one-year lead and better technology will still give it the edge over Globalstar.

PARTY TIME. To maintain his own edge and boost morale among the ranks, the 6-foot, 4-inch Staiano starts each day with a three-mile run at 6:30 a.m., eats a turkey sandwich at his desk for lunch, and works seven days a week. The longest vacation

Staiano hates missing a deadline.

"He gives absolutely no leeway," says staffer Craig Bond. "He shows no mercy"

he has ever taken is five days. "You have to be prepared to walk the same mile that the technical people in the trenches do every day," he says. "I pride myself on equal pressure on everyone."

The son of an Italian immigrant father and a Canadian-born mother, Staiano grew up in a working-class neighborhood where few kids ever considered going to college, let alone running a multibillion-dollar business. His father, Dominick, ran a produce business on Long Island, N.Y., where Ed, the middle child, grew up with his two sisters. More interested in hanging out than in pursuing an education, Staiano was "very happy driving a truck for my dad for \$200 a week," he says. But papa had loftier ambitions for his only son. To persuade Ed to go to college, Dominick Staiano even offered to buy him a car. That clinched the deal.

Once at Bucknell University, Staiano seemed to excel only at partying with his fraternity pals and working on the huge wooden floats for the homecoming parade. As a result, he wound up on academic probation. "I didn't buy any books the first year," he says. "I was there because I wanted my car." Some teachers, though, were impressed with Staiano's potential despite his poor showing. "He had a lot on the ball beyond some of the other kids who were getting better grades," says retired professor Charles H. Coder. A summer school course in engineering proved

Coder right. "It was like a switch" going on, says Staiano, who developed an instant passion for the field. Staiano went on to earn a doctorate and was teaching at Bucknell before he went to work for Motorola in 1973.

In 1984, Staiano became head of the then tiny cellular-phone unit. By 1996 the division he ran was generating \$1 billion, 40% of the company's total revenues. And Staiano had long since established his reputation as an unyielding boss. Former Motorola engineer Chris Jenner, now an executive at Sphere Communications, recalls a series of monthly quality review meetings in the spring of 1990. They tended to last four hours and proceeded along predictable lines. "One day, Ed sticks his head in," says Jenner. "He went on tirade: 'You call this a quality review?' For the next 18 months, Staiano presided over each meeting. Starting at 6:30 a.m., they lasted 12 hours. Stragglers arriving just two minutes late were met with a cold stare from Staiano. "It was definitely effective," says Jenner, who adds that he admires Staiano's work ethic.

STREET TROUBLE. By 1996, Staiano had hit a wall. Motorola was stumbling, and Staiano, now in charge of 30,000 workers, "wasn't having fun anymore," he says. Meantime, Motorola had spun off its Iridium venture and was looking for a CEO. As a member of the search committee, Staiano threw his hat into the ring and got the job.

At Iridium, Staiano's first stop was Wall Street, to raise \$2.8 billion needed to complete the system. But many investors balked. Staiano appeased skeptics by agreeing to make Iridium handset compatible with ground-based cellular systems. Calls can now bypass Iridium satellites when within range of existing networks, making them more affordable but less lucrative for Iridium.

Now, after blitzing the media with a \$180 million ad campaign, Iridium has yet to commence service. Staiano insists he's not disappointed. "To pick a date five years ago and be within a month, it is phenomenal," he says. Still, for the man who hates to miss a deadline, these are anxious times indeed.

By Catherine Yang in Washington and Roger O. Crockett in Chicago

EDWARD F. STAIANO

BORN 1936 Williston Park, N.Y.

EDUCATION BS 1958, MA 1960, Bucknell University; PhD 1967, mechanical engineering, University of New Mexico

GREATEST TEEN ACHIEVEMENT Playing accordion solo at Carnegie Hall at age 16.

LIFETIME AMBITION To be considered in the same league as Alexander Graham Bell.

FIRST JOB Driving a delivery truck for his father's produce business.

WHY HE WENT TO COLLEGE Didn't want to spend his life loading and unloading potato trucks.

MANAGEMENT PHILOSOPHY "A good manager can never have favorites."

FAMILY Married, one daughter, two grandchildren.

LONGEST VACATION EVER TAKEN Five days. "Four or five days is all I can take in a relaxed state."

HOBBIES Woodworking, cooking. Staiano's specialty: homemade marinara sauce.

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Ferdinand Piëch is determined to make Volkswagen into a global force

HARD-DRIVING BOSS

Volkswagen's lovable New Beetle might have died an early death were it not for the fanatical ambition of Chief Executive Ferdinand Piëch. In 1993, when vw was reeling from a \$1.1 billion loss, many managers viewed the little car as an unaffordable plaything. One opponent, research and development chief Ulrich Seiffert, went so far as to hide the first full-size model from Piëch for two weeks when it arrived at Wolfsburg headquarters from vw's California design studio. But Piëch, whose grandfather had conceived the original Beetle at Adolf Hitler's behest, rolled over the naysayers, stuffed the car with the technology he loves, and drove it to popular acclaim.

Reincarnating the Volkswagen Beetle is just one part of Piëch's all-consuming vision: to mold Europe's leading auto mass-marketer into one of the world's mightiest, most respected carmakers. Since taking the wheel at vw in 1993, the 61-year-old engineer has pursued that goal with obsessive zeal.

He has consolidated power, sweeping out dozens of top managers who didn't follow his lead. More important, he has launched an aggressive product offensive, from the \$10,500 Lupo mini-car just introduced in Europe to a 12-cylinder Super Passat sedan that could cost up to \$85,000 and debut in 2001. Piëch's goal: to shed vw's plebeian image and move the brand upmarket. "We're trying to redefine the status game," says Jens Neumann, a member of Volkswagen's management board and longtime Piëch lieutenant.

SPENDING SPREE. Piëch's latest gambit is an audacious assault on the ultra-luxury market. In just three months, he has bought Rolls-Royce Motor Cars for \$640 million—only to lose the rights to the coveted Rolls brand to BMW; plunked down some \$110 million for Lamborghini, the Italian maker of fire-breathing, \$240,000 sports cars; purchased Cosworth, the British specialty engine maker, for \$178 million; and snapped up Bugatti, a bankrupt Italian sports-car maker.

Piëch's dramatic moves are often viewed with awe—and sometimes be-



Portrait Of A Car Buff

APR. 17, 1937 Born in Vienna, Austria, to Anton and Louise Piëch, the daughter of engineer Ferdinand Porsche.

1942 Anton, CEO of Volkswagen's precursor, oversees production of the Beetle's Jeep-like cousin.

1963 With an engineering degree from Zurich's Technical Institute, the younger Piëch lands his first job, testing engines at sports-car maker Porsche.

1968 Promoted to head of development and of racing at Porsche. Spends millions to win Manufacturer's Championships in 1969, 1970, and 1971, firmly establishing Porsche's racing credentials.

1972 Blocked from becoming Porsche CEO, joins Audi as director of special projects in R&D.

1975 Promoted to head of R&D. Establishes Audi as a technology leader with such innovations as the Quattro all-wheel-drive and world-beating aerodynamics.

1988 Overcoming resistance from Audi's Works Council, named CEO. Continues to consult 84-year-old mother on business matters.

1993 Succeeds Carl Hahn as Volkswagen CEO. Lures cost-cutter José Ignacio López from General Motors, sparking a three-year legal battle with GM over charges Lopez stole confidential GM documents.

1998 Tries to push VW upmarket. Buys Italian sports-car specialist Lamborghini and Britain's Rolls-Royce. BMW outfoxes Piëch, winning rights to the Rolls name and trademark.

wilderness—by everyone from competitors to VW shareholders. From his controversial hiring in 1993 of General Motors Corp.'s cost-cutting ace José Ignacio López to his fathering of more than a dozen children by at least four women, Piëch seems to make up his own rules in life. He declined to be interviewed for this story. But conversations with former colleagues and classmates paint a picture of a combative yet insecure man who is driven by a deep desire

to match his grandfather's mythical stature. "He wants to prove that he has been underestimated for years," says a former Volkswagen executive.

Whatever his personal quirks, Piëch has steered VW into astounding success. When he took over, the carmaker was so inefficient that it could make a profit only by working factories overtime—a bad predicament when the industry is in a sales slump. Piëch hammered VW into a company fit to compete with such giants as GM, Ford, and DaimlerChrysler. In just five years, he turned around the moribund SEAT and Skoda brands, widened VW's lead in Europe, engineered a comeback in the U.S., and strengthened the company's grip in emerging markets from Central Europe to Latin America. "He is the most brilliant and forward-looking CEO in the business today," says an analyst for a major VW investor who rarely praises the company.

In Europe, VW has grabbed 1.2 points of market share since 1993, bringing it to 17.5% (charts, page 84). Archrival GM, meanwhile, has slipped nearly two points to a distant second, at 11.3%. In the U.S., the first market to get the New Beetle, the \$16,500 Bug, launched this spring, is powering VW's revival. The perky car draws shoppers into showrooms, where they are suddenly buying every model in sight. VW's U.S. sales are up 61% so far this year, and the company expects to deliver 200,000 cars in 1998, the most since 1984.

Analysts expect VW to report about \$1.3 billion in net income in 1998, on sales of \$75 billion—an earnings jump of 60%. But conservative German accounting understates performance. VW will actually earn \$2.1 billion in 1998, and \$2.6 billion in 1999, based on international accounting rules, figures John K. Lawson, auto analyst at Salomon Brothers in London.

The danger with Piëch is that his personal ambition could cause him to overreach. Moreover, his iron grip on VW means there are few checks and balances on his decisions. Piëch has shrunk VW's management board to just five members, from nine before he took the top job. He holds personal responsibility for R&D, production, purchasing, and the VW brand—areas typically assigned to individual directors. Critics say that the Rolls-Royce blunder, which leaves VW

with only the lesser-known Bentley brand after 2002, shows the CEO has too much influence, especially over the company's 20-member supervisory board. "At VW, nothing happens without Piëch," says a former colleague.

Piëch's success has been fueled by engineering knowhow, a passionate love of cars, and enormous wealth. His family's

sprawling, Salzburg-based business empire, which includes hotels and auto importers across Europe, is estimated to be worth more than \$3 billion. That background, some say, gives Piëch a psychological advantage in confrontations with ordinary mortals for whom job loss is a financial threat.

QUANTUM LEAP. Former classmates say that as a student at Zurich's Swiss Federal Institute of Technology in the early 1960s, Piëch threw himself into automotive studies with single-minded intensity. He toiled around in a Porsche and spent his spare time tinkering with it. Once, over Christmas vacation, he modified the engine, omitting the heater. Then he drove 300 miles from his family's home in Austria to Zurich, over the snowy, 5,900-foot Arlberg pass. "He almost froze to death," says Werner Kalin, a classmate who now works at the Swiss embassy in Washington. "I asked, 'Don't you have a heater?' He said, 'There was no room.'"

Now, Piëch mainly tinkers with new models that VW is developing, regularly joining test drives of prototypes—a task typically delegated to development engineers. His close involvement in new projects approaches that of a control freak. After taking the helm of VW, he threw himself into work on the Passat, a \$21,700 family sedan that made its debut in 1997. It was the first all-new car to be developed on Piëch's watch, and he wanted it to help shake VW's



TRACK MAN

In the 1960s, Piëch helped turn Porsche into a maker of world-beating race cars

image as a maker of solid but stodgy vehicles. Using Mercedes as a yardstick, Piëch ordered a quantum leap in quality. He insisted interiors be outfitted with rich fabrics and high-quality plastics that mimic leather. In 1996, before journalists tested the first production models, Piëch personally drove nearly 60 cars to be sure they were in tip-top shape.

The car won rave reviews, beating Mercedes and BMW models in comparison tests by German car magazines. That helped make it a sellout, forcing VW to add capacity at its plant in Saxony. Passat worldwide sales this year could hit 400,000, up from 370,000 in 1997. "VW was able to build up a [price] premium over other manufacturers, like Fiat, Opel, and Ford," says Dieter Zetsche, a Mercedes managing director. "That's quite an achievement."

DARK SIDE. Piëch's lifelong fascination with cars gives him a nose for cutting-edge technology that wows customers. In the 1970s and early 1980s, while research director at Audi, he propelled such breakthroughs as full-time four-wheel-drive for passenger cars. The aerodynamic design for the Audi 100, launched in 1982, stunned the world with its curvy contours and record-low wind resistance. The car won awards and spawned copycats, including Ford Motor Co.'s Taurus, which quickly became the best-selling car in the U.S. And in the 1990s, Piëch promoted a newly developed direct-injection diesel engine that combined the fuel economy of a diesel with the quiet, zippy performance of gasoline engines. Such competitors as GM and Renault are just now beginning to catch up.

Piëch's visionary leadership has a dark side. VW's achievements since 1993 have come in a virtual autocracy. Piëch's will prevails from the R&D center all the way up to the management board. Executives who question his ideas and decisions often get the boot. In his first three years at the helm, Piëch tossed out more than 20 top managers, including two Audi CEOs. At meetings, "critical questions



aren't asked,

because people know things can rapidly get uncomfortable," says an executive who worked closely with Piëch for several years.

Colleagues know immediately when the boss is upset. His blue eyes flash with anger, and he intimidates subordinates with long silences. Indeed, in an era when team-building and employee empowerment are in vogue, Piëch prefers fear as a motivator. Former VW executives say Piëch likes to keep people off balance, making surprise visits to offices, VW's technical center, or the vast Wolfsburg factory.

Even when a loyal subordinate does well, Piëch is stingy with compliments. Close ally Neumann has received few kudos from the boss for resuscitating VW's U.S. operations—which the company considered abandoning just five years ago. "He is not a man who expresses his praise," says Neumann of Piëch. Piëch's heavy hand so riled VW managers in late 1994 that they sent an open letter to supervisory board Chairman Klaus Liesen. "Herr Doktor Liesen," it began, "this company is run by a man with psychopathic traits."

BEETLE

Despite critics, Piëch loaded the car with technology and drove it to acclaim

Liesen asked Piëch to tone down his rhetoric.

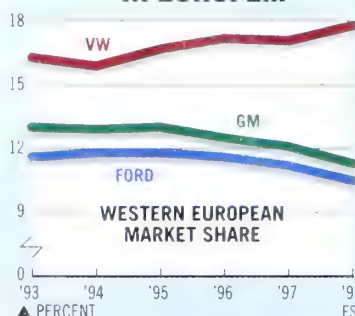
If Piëch seems to drive VW like a personal fiefdom, the tendency may be in his genes. The year he was born, his maternal grandfather, Ferdinand Porsche, helped plan the factory

Wolfsburg that would build the first Beetles—along with parts for tanks, aircraft, and other weapons. His father, a Viennese lawyer named Anton, came CEO of the fledgling Volkswagen in 1941. At the height of World War II, Anton focused production on a few products, such as Beetle-based Jeeps and aircraft engines, in an effort to make the state-owned company profitable. Many of the factory's workers were slave laborers from eastern Europe. In September, VW set up a million fund to help support the workers still living.

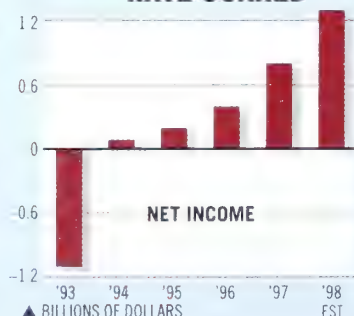
The split between the Porsche and Piëch clans dates to the same era. Perhaps sensing Germany's fate, in 1945 Anton and his wife, Louise Porsche, negotiated an agreement with Ferdinand Porsche and Louise's brother Ferry Porsche to take over Porsche's engineering businesses in Austria. A portion of the business located in Stuttgart remained with the Porsche family. After the war, Ferry began developing sports cars based on the Beetle, products that would soon make Porsche world-renowned. The families have since agreed to joint ownership, both the German and Austrian companies, but friction nonetheless smoldered between the two.

It rankles Piëch that he can't bask in the glory of the Porsche name. He played a key role in burnishing the spo-

VW HAS PULLED AHEAD IN EUROPE...



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car maker's image. Fresh from university, he joined Porsche's engine-test department in 1963, and by 1968, he was named head of development and of racing. Immediately and obsessively, he launched an all-out campaign to win the coveted Manufacturer's World Championship and its most famous race, the 24-hour Le Mans. "Nobody believed it could be done because of the financial strain and the manpower strain," says Brian Redman, a Briton who drove for Porsche in 1969 and 1970. Porsche invested millions in race cars, refining the existing 908 model and building a radically new, 240-mile-per-hour car, the 917. **QUATTRO COUP.** Piëch persevered, and his efforts paid off grandly. In 1970, Porsche won 9 of the season's 10 races, including Le Mans for the first time. In 1971, Porsche dominated again, winning eight of 11 races. That cemented the company's reputation as a maker of world-beating race cars. "In everything that [Piëch] tackles, he wants to be No. 1," says a former colleague.

Despite his success, Piëch's domineering, free-spending ways angered some Porsche family members. When it became clear that he would never be CEO, Piëch bolted, taking a job in Audi's

R&D department. There, he began a 20-year climb to the top of VW, rising through the engineering ranks to become Audi CEO in 1988. With sporty cars and cutting-edge technology, he invigorated a brand that had been derided as the boring choice of retired civil servants. At the Geneva auto show in 1980, Audi unveiled the Quattro, a 200-horsepower coupe that was the first modern production car with full-time all-wheel drive.

Soon, all Audi models were being offered with four-wheel drive, and rivals were scurrying to develop competing models. That success earned Piëch the top job at VW in 1993.

There, one of Piëch's pet projects was to update his grandfather's classic, the Beetle. The new version, now being



launched in Europe, was initially based on the same platform as VW's small Polo. Piëch believed it would be too cramped and ordered designers to shape it around the larger Golf. He also crammed it with the latest technical goodies, such as standard side airbags. There were plenty of skeptics inside



SOLO ACT

Piëch's iron grip on VW means there are few checks and balances on his decisions. Will he overreach?

VW who didn't understand how the car plucked at people's heartstrings and thought the company should pour its scarce resources into the more practical Golf. But, as usual, Piëch prevailed.

red-shuttered, lakefront home outside Zell am See, a pretty resort town in central Austria. He sits on the supervisory board of Porsche Holding, one of VW's largest importers, and is a board member of Stuttgart-based Porsche, in which the Piëch family has a 34% stake.

There is more to his tremendous power within VW than family history, however. Ever since opposition from Audi's works council delayed for a full year his promotion to CEO of the division, Piëch has forged a strategic alliance with VW's labor bosses. During the crisis of 1993, Piëch avoided layoffs, even though he had himself estimated the company had 30,000 excess workers. Instead, he agreed to a 20% reduction in work time, to 28.8 hours a week, with a 16% pay cut. In return, VW's labor reps, who by law hold half the seats on VW's supervisory board, have backed Piëch's power grabs and approved his expansion plans.

Like most workaholics, Piëch has little time for recreation. One consistent pastime over the years, however, has been making children. He has three with his current wife, Ursula, who was nanny to his three children with his live-in companion during the 1980s. He

also has five children from his first marriage. The German press claims he has a total of 13 children, a figure he has never disputed. Now, industry executives whisper that he is expecting his 14th child—and not with his wife. He was once quoted as saying that the more children he fathered, the greater the chance that his genius would be passed to the next generation.

GLARING RISKS. Such odd fancies fuel Piëch's reputation among many former VW executives and investors as an unpredictable, potentially dangerous chief. This is reflected in VW's stock, which recently stood at 3.9 times expected 1998 earnings, compared with six times earnings for Daimler Benz. The lack of critical debate within VW raises the risk of a major Piëch blunder.

Critics point to the botched purchase of Rolls-Royce Motors from Britain's Vickers PLC as an example of how things can go seriously awry. Piëch, who dreamed of buying Rolls for at least a decade, pushed the \$640 million purchase despite two glaring risks. Rights to the Rolls-Royce name and trademark belonged to Rolls-Royce PLC, the aerospace company, which has no connection to the luxury-car maker. Moreover,

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King Fahd



Crown Prince
Abdullah

People

rival BMW, which supplied the engine, transmission, climate control, and electronics for the new \$216,400 Silver Seraph model, threatened to halt deliveries if VW won Rolls.

TOUCHY ISSUE. Nonetheless, members of VW's supervisory board O.K.'d the purchase, partly because Piëch assured them that these problems were minor. They were stunned in September when BMW won the rights for a mere \$60 million, stealing the gold-plated brand from under Piëch's nose. VW is left with the lesser-known Bentley brand. VW plans to develop a smaller, less expensive Bentley model that would slot in below the new \$203,900 Arnage. The company is also trying to find a way to win Rolls Royce back from BMW. "You haven't heard the last word on Rolls-Royce," says a company spokesman.

Piëch's management style makes the issue of his succession a touchy one. Critics both inside and outside the company charge that, after so many purges, the CEO is now surrounded largely by yes-men. There is growing concern that if an accident befell Piëch

or he left the company suddenly, he would leave a giant power vacuum. Some supervisory board members want to expand VW's management board again to spread the workload more evenly. "At some point, those positions will have to be filled, because there will also be a time after Piëch at VW," says Bernd Sudholt, deputy chairman of VW's works council and a supervisory board member.

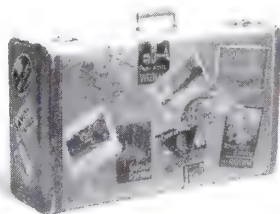
With his track record, however, and with the New Beetle perpetuating the Volkswagen cult around the world, Piëch can argue there's little reason to

UPMARKET

Piëch paid some \$110 million for Italian sports-car maker Lamborghini

reduce his power. His way of bulldozing any opposition means that restructuring VW's management would be uphill work. Piëch is at his fiercest when he encounters resistance. It's likely that unless a serious mistake casts doubt on his skill, he will keep on doing whatever it takes to live up to his vaunted heritage.

By David Woodruff in Frankfurt with Keith Naughton in Detroit



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STRATEGIES

P&G'S HOTTEST NEW PRODUCT: P&G

A soup-to-nuts redesign aims for global speed and focus

At Washington State's Clark County Fair last month, coffee lovers got a front-row seat at a corporate revolution in the making. The local sales force for Procter & Gamble Co. was out in force at the Pancake Feed, distributing samples of P&G's Millstone Coffee. To the amazement of the Fred Meyer supermarket employees running the pancake breakfast, the Procter reps worked the crowd, chatting with customers, even taking turns in the full-size coffee-maker costume with the cup-and-saucer hat. "You don't generally see them out there doing that kind of grassroots work with customers," says Jeanne Lawson, a Fred Meyer buyer. Procter is better known for serving up advertising dollars and display-design tips, she says. "I'd never seen anything like it."

But then, P&G has never needed or-

dinary customers quite so badly. Battered by disappointing revenue growth and demanding retail customers, Procter & Gamble is a company in a bind. Two years ago, its executives boldly declared that the consumer-products giant would double its net sales by 2006, to \$70 billion. P&G has consistently missed its growth targets ever since. Olestra, the company's high-profile fat substitute, more than a decade in development, is showing weak sales. And global economic turmoil is crimping overseas operations. Shares have dropped from \$94 apiece in July to \$70. The behemoth so used to leading the pack is looking lost.

So P&G, a company notorious for secrecy, has set itself on a remarkably outward-looking self-improvement plan. Breaking from decades of tradition, it has sought external advice. It is undergoing a structural shift prompted at

least in part by outsiders—namely, its big chain-store customers. And it is already rolling out an aggressive global marketing blitz, from working the fair grounds to marshaling the Internet.

Chief Executive John E. Pepper will step down about two years early to make way for President and Chief Operating Officer Durk I. Jager, who will drive the changes. It's a shift away from internal themes of recent years in which Procter focused heavily on such tasks as cost-cutting and shedding underperforming brands. But even as the giant revs its engines to push for faster sales growth, critics wonder if it can overcome both economic turmoil around the world and what will surely be cultural turmoil within its own ranks. "This is a very big deal, for Procter and for all the companies that watch Procter moves," says Watts Wacker, chairman of consulting firm FirstMatter in Westport, Conn. "But great plans often come with great obstacles."

SIMPLIFY, SIMPLIFY. In preparation for the task, Pepper and other top executives have been traversing the country, visiting the CEOs of a dozen major companies, including Kellogg Co. and 3M, in search of advice. Pepper went to Jack Welch at General Electric Co. to learn how the company streamlined global marketing. He persuaded Hewlett-Packard Co. CEO Lewis E. Platt to share enough secrets about new-product

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development to make a 30-minute instructional video for P&G staffers. The message from all was clear, says Pepper: "What thousands of people have been telling us is that we need to be simpler and move faster."

The result of this unprecedented road trip is Organization 2005, a shuffling of the P&G hierarchy and a new product-development process designed to speed innovative offerings to the global market. The old bureaucracy, based on geography, will be reshaped into seven global business units organized by category, such as baby care, beauty care, and fabric-and-home care. The global business units will develop and sell products on a worldwide basis, erasing the old system that let Procter's country managers rule as colonial governors, setting prices and handling products as they saw fit.

SWIFT ROLLOUT. This new global vision has already had an accidental test run. Last year, P&G introduced an extension of its Pantene shampoo line. The ad campaign for the product was almost entirely visual, with images of beautiful women and their lustrous hair, and had a very limited script. That meant the campaign was easily translated and shipped to P&G markets around the world without the usual months of testing and tinkering. The result: P&G was able to introduce the brand extension in 14 countries in six months, vs. the two years it took to get the original shampoo into stores abroad. "It's a success story that gets quite a bit of talk internally," says Chris T. Allen, a marketing professor at the University of Cincinnati, who spent his sabbatical year working in the P&G new-products department. "I see the reorganization as an attempt to do more Pantenes on a regular basis."

P&G didn't come to this global focus entirely on its own. Its biggest chain-store customers, such as Wal-Mart Stores Inc. and French-owned Carrefour, have been agitating for just such a program to mirror their own global expansion. It has been Topic A at retail conventions for months, says Robin Lanier, senior vice-president for industry affairs at the International Mass Retail Assn. While P&G craves an international image for its products, retailers want something more tangible: a global price. As it stands, prices are negotiable on a country or regional basis. What an in-

PROCTER & GAMBLE'S GAMBLE

THE PRESSURE Big international retailers such as Wal-Mart Stores and Carrefour are pushing suppliers such as P&G for standardized worldwide pricing, marketing, and distribution

THE PLAN Procter is undergoing a major shift in its organization, moving away from its country-by-country setup to a handful of powerful departments that will supervise categories such as hair care, diapers, and soap on a global scale

THE RISKS Procter's plan will take two years to implement and depends heavily on increasing market share and sales volume in international markets, many of which are reeling from economic instability

ternational retailer pays for Crest in the U.S. could be considerably less than what it costs the chain in Europe or Latin America. A consistent global price gives big chains more power to plan efficiently and save money. Wal-Mart Chief Executive David D. Glass describes his company's goal as "global sourcing," which includes worldwide relationships on pricing and distribution. Moving P&G products from regional to global management is "pointing somewhat in that direction," Glass says.

In addition to marketing and pricing, global business units will supervise new-product development. P&G will move away from its long-used "sequential" method, which tested products first in midsize U.S. cities and then gradually rolled them out to the world. An example: Swiffer, a new disposable mop designed by P&G, is being tested simultaneously in Cedar Rapids, Iowa; Pittsfield, Mass.; and Sens, France, in hopes of sculpting a globally popular product right out of the box.

Jager concedes that it won't be a quick fix. The new regime won't start until January and won't really be functioning for about 18 to 24 months. He expects to see some top-line growth improvement within 12 to 16 months, with obviously better results two years out. Many observers doubt that will be fast enough to make the 2006 deadline. "[The plan] seems to work on paper, but it requires an accelerated sales growth in the final four years," says Constance M. Maneaty, an analyst at

Bear, Stearns & Co. "We haven't seen that kind of sales growth from them in a while."

Even if P&G could implement its strategy more quickly, it would still run into the ugly realities of global economic markets. For its extra \$35 billion in revenue through 2006, Procter is counting on about \$8 billion from emerging markets in Eastern Europe, China, and Latin America, says Claytor C. Daley Jr., P&G's treasurer who becomes chief financial officer in October. Yet Asian emerging markets are likely to remain mired in deep eco-

nomie slumps for at least two more years. Recent turmoil in Russia, which was a bright prospect for Procter just a year ago, has gotten so bad that the company has temporarily halted shipments there. "Growing in underdeveloped geographies is clearly questionable," says Jay Freedman, an analyst at Lincoln Capital, a big institutional holder of Procter & Gamble stock. "Whatever they thought the purchasing power of those new customers was going to be is less now."

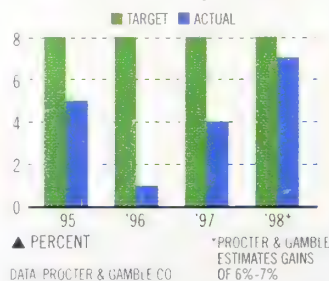
"A LOT OF EX-CHIEFS." Procter has additional obstacles closer to home. However, for example, will tradition-bound P&G managers react to the new hierarchy? "You're going from 144 chiefs to 8. That's a lot of ex-chiefs," says consultant Wael A. And everyone will be affected by the change in tone that is sure to come from the corner office. Gentlemanly Pepper, 60, will be succeeded by Jager, a Dutch-born P&G lifer with a reputation for aggressive moves and abrasiveness. In the 1980s, he turned around Procter's failing Japanese business with such a fury that his Japanese managers called him "Crazy Man Durk" behind his back.

Crazy or no, Jager is sticking to the 2006 target date. He's wasting no time stepping into his new role as champion of the global focus: Already, even before taking on the official title of CEO, he has started preaching the new structure to P&G managers. After all, the clock is ticking.

By Peter Galuszka in Cincinnati and Ellen Neuborne in New York, with Wendy Zellner in Dallas

MISSING THE MARK

Procter & Gamble's net sales growth hasn't been strong enough to propel it to its goal of \$70 billion by 2006



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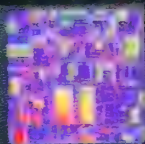
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The Computer Inside



STRATEGIES

DEATH BE NOT (SO) PROFITABLE

Lower mortality rates have left funeral players such as Service Corp. scrambling for new growth sources

From education to housing to health care, the arrival of the baby boomers has been the defining demographic event for many an industry. And few companies have anticipated the boomers' evolution as eagerly as \$2.7 billion Service Corp. International, the biggest and most profitable of the funeral home consolidators. Through the past two decades, the Houston company has assembled nearly 3,300 funeral homes around the world and recorded rich 25% operating profit margins, fueled by a steady 1% yearly rise in deaths.

But now, demographers

see growing evidence that medical advances and healthier lifestyles are letting more of us defer the day of reckoning. In a dramatic change from past projections, age-adjusted deaths in the U.S. fell 3% last year on top of smaller declines the prior two years, according to the Centers for Disease Control & Prevention. Experts say the key causes are advances in HIV treatment, post-surgery heart care, and new strides in low-birthweight infant survival—and

that the trend should continue. "The decrease in the death rate is based on solid progress that shouldn't reverse," insists Dr. Charles G. Hertz, chief medical director of Metropolitan Life Insurance Co. and editor of the demographic and health-care journal, *Statistical Bulletin*.

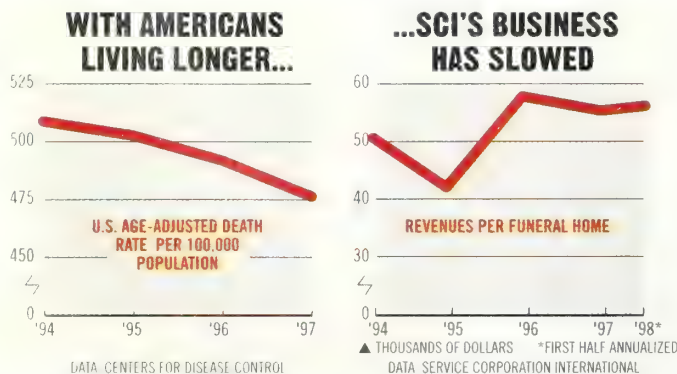
That news, while encouraging for most of us, is forcing SCI to alter its growth strategy. After a torrid pace of funeral home acquisitions—SCI has bought more than 1,800 homes since 1995—the chain is downshifting its dealmaking and cranking up sales of "pre-need," or prearranged funerals to boost revenues. It recently created a finance division as part of a plan to profit from selling life-insurance policies tied to funeral costs. Even with the market slowdown, "we can expand future revenues by expanding pre-need [sales]," insists SCI President L. William Heiligbrodt.

"BRILLIANT." While still enjoying growth from acquisitions, SCI's revenues per funeral home have slipped 5% since 1995 (chart). Earnings this year are still expected to rise 20%, to \$400 million, as a result of price increases and acquisitions. Others in the industry have been harder hit. In July, the second-largest funeral home operator, Loewen Group Inc. of Burnaby, B.C., put itself on the block, blaming "soft" mortality rates for a failed turnaround. Loewen's earnings fell 56%, to \$11.6 million, in the quarter ended June 30, on an 8% drop in revenues per funeral home.

Investors, meanwhile, have cooled on funeral-industry stocks. In addition to concerns about the improving death rate, the entire sector is sagging over worries that the consolidators' frenetic dealmaking has driven up prices for funeral homes to the point where many further acquisitions don't make economic sense. The Pausz Tombstoner index of death-care stocks is up 14% compared with the 6% gain in the

Standard & Poor's 500 stock index. SCI, once Wall Street darling because of its persistent 20%-plus annual earnings gains, is trading at 39% up 6% for the year.

It's not as if funeral homes can exactly expand their customer base. But SCI figures that it can grow some future business before it matures. That was the motivation behind two recent buys. On July 1 it purchased, for \$164 million





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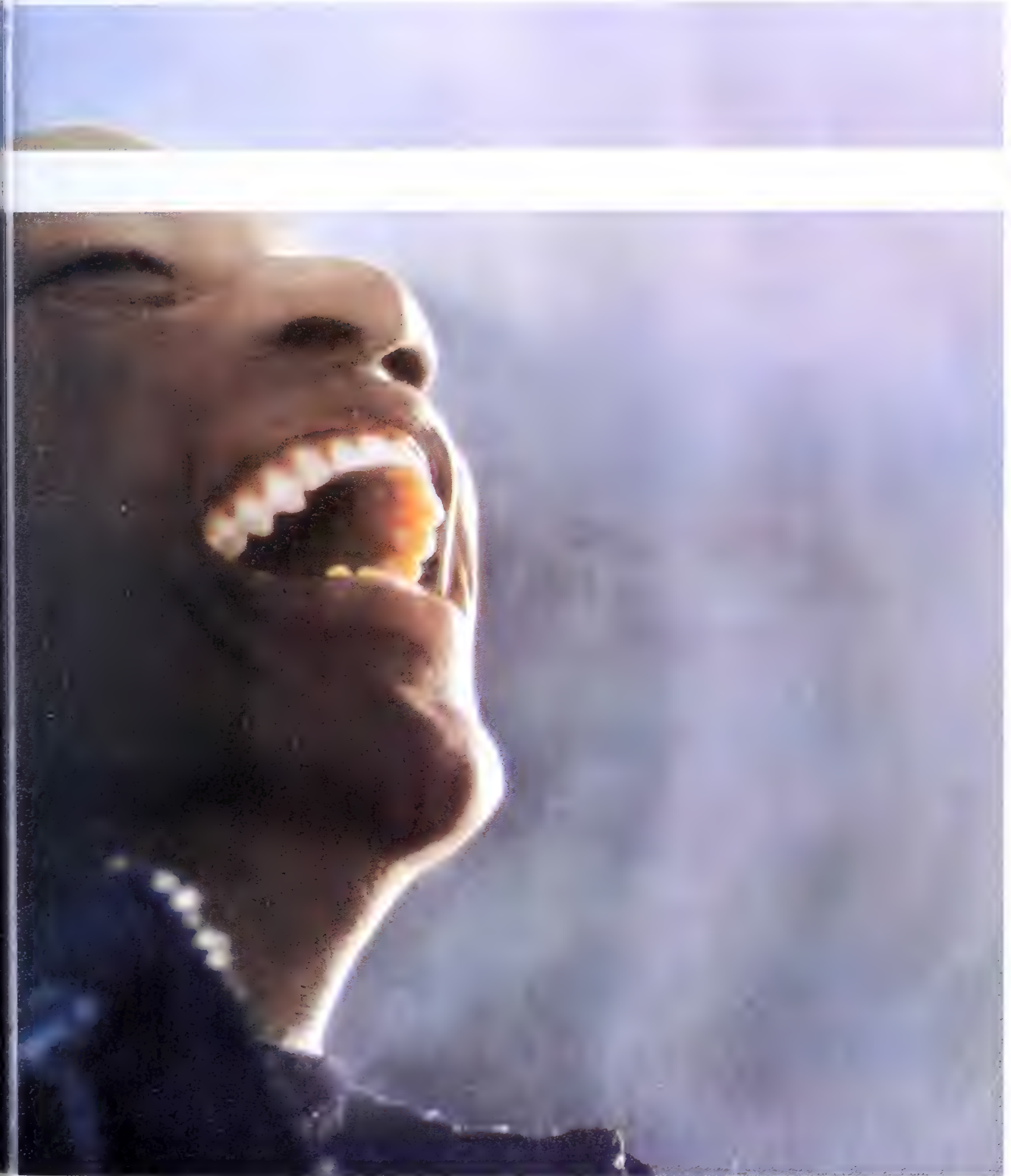
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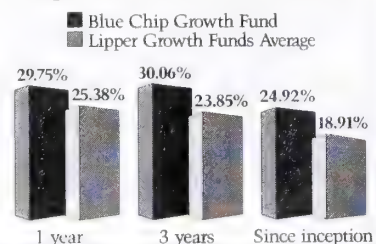
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The Corporation

lion, an American Annuity Group Inc. unit that underwrites prearranged funeral policies. Three weeks later, SCI agreed to pay \$830 million for rural funeral and cemetery operator Equus Corp. International, a spin-off SCI had only finished divesting in January, 1997. That spin-off had figured into SCI's plan for an unsuccessful attempt to buy Loewen; now, it may fit in with the new strategy.

Since 1995, SCI has boosted its annual sales of prearranged funeral policies from \$371 million to about \$700 million. Typically, such sales don't immediately add to revenues until the services are delivered. But owning the insurance unit enables SCI to profit immediately from the underwriting, taking transaction profits of 12% to 15% at the time of sale—and locking in future revenue. "This is a way to sell pre-need, service more families, and make this additional profit. It's absolutely brilliant," says Daniel M. Isard, president of Foresight Analysts Inc., a Phoenix death-care consulting company.

DEAD AGAIN. In the meantime, the rupee in funeral home prices is likely to crimp acquisitions. SCI recently broke up a corporate acquisitions group and shifted its employees into funeral, cemetery, and finance divisions. The intent is "to get better decisions and better business," not fewer deals, says Heiligbrock. While acquisitions will play a smaller role in its future growth, "we're not going to abandon the acquisitions business," he insists.

Of course, improved health and medical care don't mean that we will live forever—and the numerous baby boomers will inevitably increase demand for funeral services. "This isn't a product you can walk away from," says J. Morgan Securities analyst Josey Chiarelli. Even if the nation's mortality rate doesn't soon return to the past rate of annual increases, the aging of the boomers suggests that the number of deaths should begin to climb rapidly within a decade. The fastest-growing segment of the U.S. population is that which is 65 and older; it is expected to double, to 4 million, between 1990 and 2000. "A good management team will find a way to get through this period," says Chiarelli.

If he's right, the years of easy growth could quickly return. But that's assuming medical advances don't intrude on other key causes of death, such as cancer. Death and taxes are inevitable—but the timing of them may be another thing altogether.

By Gary McWilliams in Houston

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THE CIO IS IN THE hot seat as the executive

committee drills one department head after another on escalating costs. How are you going to ¹ (get the newly acquired subsidiary onto our e-mail system)? How are you going to ² (hold down your network administration head count) as you add hundreds of new users? How can you afford to ³ (roll out new apps to the whole company)? It's like the Spanish Inquisition, but the food is worse. Her stomach rumbles from the dry turkey sandwich and yuppie water served at the start of the meeting as one committee member wakes up long enough to ask about the ⁴ (Year 2000 problem) he saw on a CNN segment. "Not a problem, we have it covered," she replies. With an unforeseen compliment for completing the ⁵ (global supplier extranet) project, she is excused. Exiting, she smiles at the beleaguered marketing director, who is about to be skewered because the company's celebrity pitchman has just appeared on the cover of a supermarket tabloid.

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COMMENTARY

By Paul Raeburn

HOW NASA CAN SURVIVE ITS MIDLIFE CRISIS



October, 1958, was a jittery time in cold war Washington. Nuclear sabers were rattling, and everyone was concerned about an arms race in space. A year earlier, the Soviet Union had launched a 22-inch, whiskered aluminum ball called Sputnik, the world's first man-made satellite. Its scratchy radio transmission soon became the bleep heard 'round the world.

President Eisenhower and Congress moved swiftly to respond, and on Oct. 1, 1958—40 years ago this week—the National Aeronautics & Space Administration opened for business. The space race was on.

LOST FOCUS. As NASA celebrates its 40th birthday with a small gathering at its headquarters, it might look

back on those frenzied early days with longing. In 1958, NASA didn't have to explain its mission. With the constant thrum of the cold war in the background, the need for a space program seemed beyond question. Although NASA was a civilian agency, one of its principal objectives was "to gain stature for the nation in the general struggle with world communism," according to a 1959 review by the RAND Corp. that has just been declassified.

NASA accomplished that goal by surpassing the Soviets, beating them to the moon and pulling ahead in unmanned exploration of the planets. Now, NASA finds itself in a midlife crisis, searching for a new mission. On two fronts—the human exploration of space and scientific discovery—NASA sagged badly during the past two decades.

On the human front, the space shuttle never generated the pure excitement of the moon flights. NASA also stumbled with the space station. Since 1984, NASA has spent more than \$20 billion on the station and has yet to get a single piece of hardware off the ground. An independent review in April predicted that the station will not be completed until 2005, three years late and \$7 billion over budget. And NASA has now asked for \$660 million to bail out its Russian partners, crippled by their failing economy.

NASA's unmanned scientific research program likewise lost its focus. Missions went over budget, some were canceled, and the Hubble space telescope was sent aloft with a bad case of astigmatism.

NASA can and should get back on track. The agency should acknowledge that it is dedicated to both of its primary objectives—the scientific missions and the human exploration of space, which is a worthy goal independent of its scientific value. Congressional support to meet these goals remains strong: Although NASA's budget has been trimmed during the past few years, Congress has given NASA almost as much money in the 1990s (after adjusting for inflation) as it did in the 1960s, during the Apollo heyday.

CULTURE CHANGE. During the past few years, NASA has finally begun to shake off its torpor and get moving again. Much of the credit should go to NASA Administrator Daniel S. Goldin, an aerospace engineer who

took over the agency in 1992 after 25 years at TRW Inc. Goldin "has changed the culture," says Marcia S. Smith, a longtime science policy analyst at the Congressional Research Service. He has made "faster, better,

NEW MISSION:

John Glenn (bottom, second from left), the first Mercury astronaut to orbit the earth, retraining for another trip





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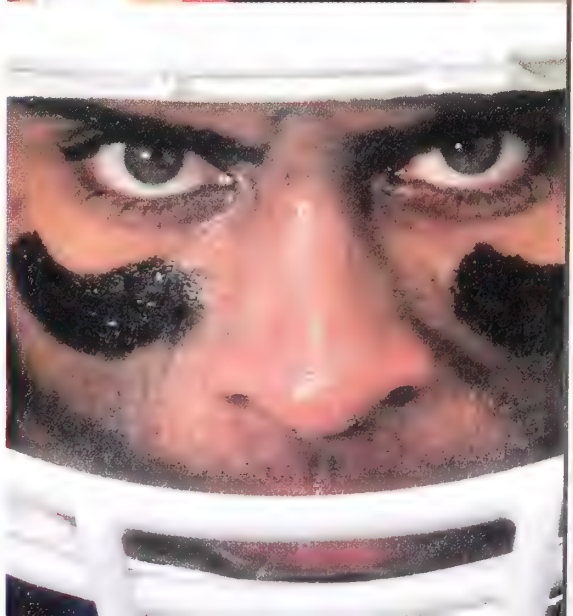
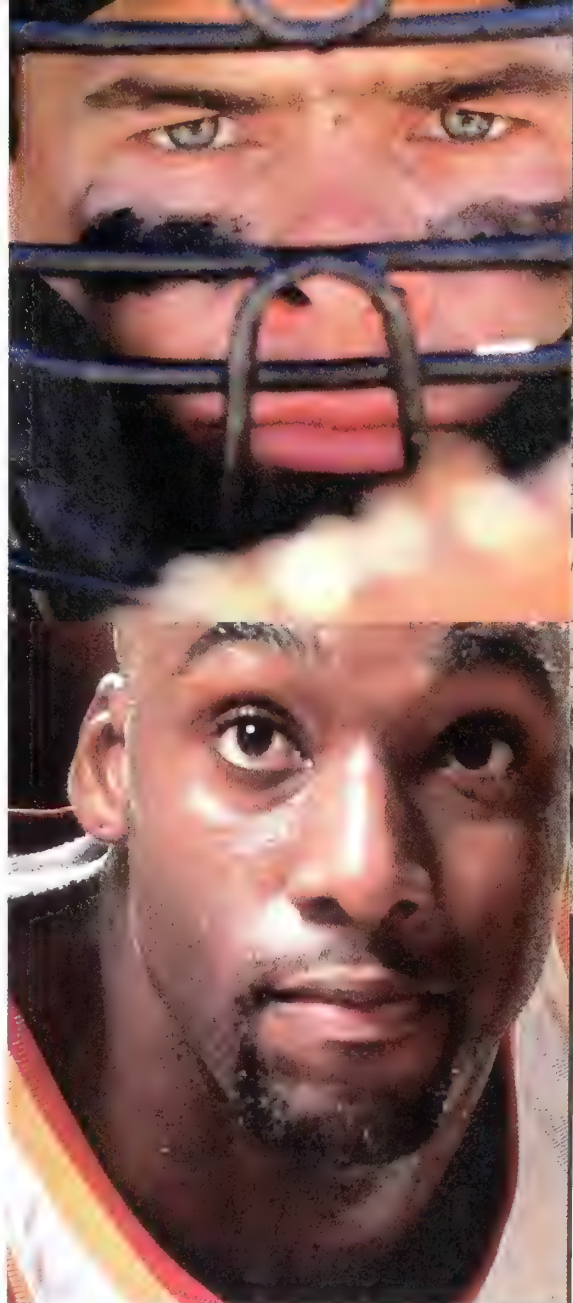
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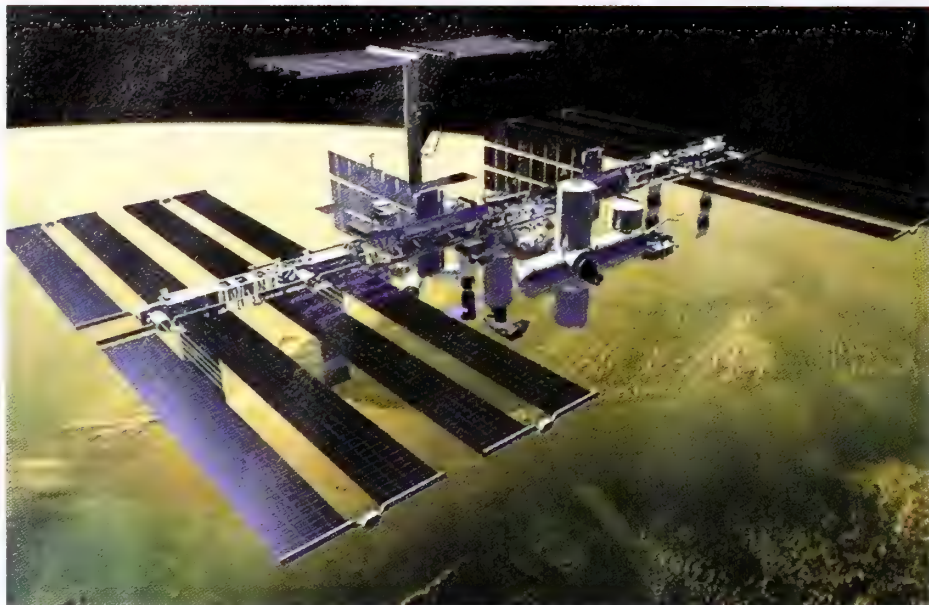
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BLACK HOLE? *The international space station is delayed and over budget*

cheaper" NASA's new mantra and shifted operations costs to private sector partners so NASA can keep its focus on research and development.

Last summer's Mars Pathfinder mission was a striking demonstration of the principle: NASA sent a spacecraft to Mars, drove a tiny rover around the surface, and attracted 900 million hits on the Pathfinder Web site—all for \$250 million. As the Pathfinder team liked to point out, that was less than it cost to make the movie *Titanic*. Not content with occasional missions to Mars, however, NASA has now established a Mars exploration program extending well into the next century—the next two spacecraft will be launched around

A FLIGHT PLAN FOR NASA

NASA is recovering from its sluggish performance during the past two decades, thanks largely to Administrator Daniel S. Goldin.

Now the agency should:

- ▶ Continue to move operational and other expenses to the private sector
- ▶ Pursue scientific discovery and human space exploration as two separate and equally worthwhile goals
- ▶ Devise long-term plans in both areas to obtain stable funding from Congress

the end of this year.

NASA could, however, encounter an iceberg ahead. The agency has begun its transition, but the job isn't finished. The most serious difficulties are in the human exploration program. The space station has so far generated little public enthusiasm. It has been designed, cut back, and redesigned so often that the public has little idea what it is supposed to do. It was promoted by NASA as a scientific mission, but the station is primarily about human exploration and living in space, not about science.

Some critics would scrap the station in favor of a bolder project—a return to the moon, perhaps, or a human mission to Mars. "NASA should send humans to Mars by 2008," says Robert Zubrin, the founder of Pioneer Astronautics, which does contract research for NASA, and the president of the Mars Society, a group formed in August to lobby for a human Mars mission. "The fundamental purpose of NASA is to open the solar system to humanity—and, by so doing, maintain the definition of the United States as a nation of pioneers," he says.

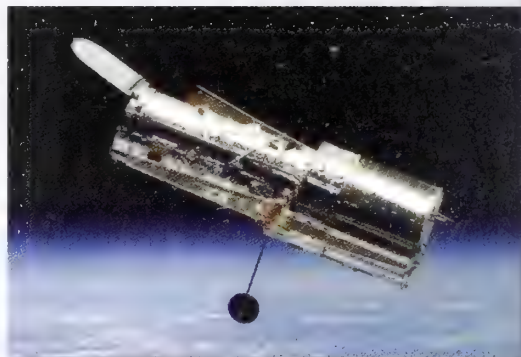
Whether or not it goes to Mars, NASA should not be forced to choose between science and exploration. Pathfinder showed that NASA still has the engineering brilliance and imagi-

nation that makes almost anything seem possible. The Hubble space telescope, now repaired, has provided a spectacular demonstration of NASA science. In November, the first elements of the space station will be launched aboard a Russian missile, and a second package will be carried aloft by the shuttle in December.

SPACE HERO. NASA's big fall event, however, occurs Oct. 29, when 77-year-old Senator Glenn (D-Ohio) is scheduled to make his second flight into space, 36 years after becoming the first American to orbit the Earth. NASA insists Glenn's flight will answer important scientific questions about aging in space—but that's a flimsy justification. Glenn's flight isn't about sci-

ence; it's about sending a space hero back up for another triumphal flight. That alone is reason enough to do it.

AS NASA continues to reinvent itself, it is asking Congress for stabili-



SPECTACULAR: *The Hubble telescope paid off*

ty in its budget over the next five years to allow better planning. With careful attention to paring unnecessary expenses, NASA can pursue first-class science—and the human exploration of space.

In the meantime, NASA can thank the old Soviet Union for Sputnik. The spacecraft tumbled back into the atmosphere and burned up only three months after it was launched, but that brief flight led to the creation of an agency that still embodies the American frontier spirit.

Raeburn is BUSINESS WEEK's senior editor for science and technology. John Carey, senior correspondent in Washington, contributed reporting.

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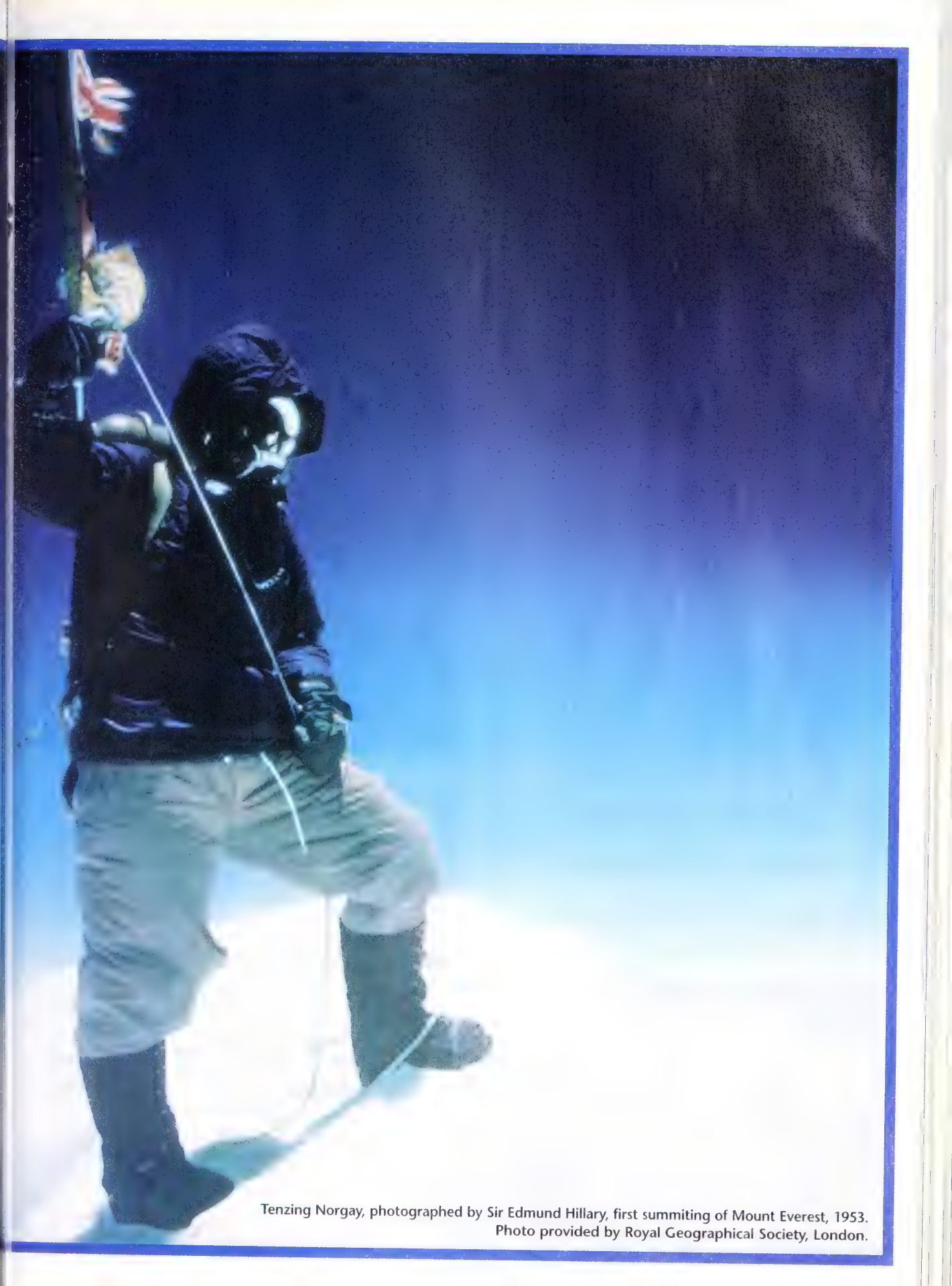
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Tenzing Norgay, photographed by Sir Edmund Hillary, first summiting of Mount Everest, 1953.
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YOU DESERVE A STARCH CONTAINER TODAY

IF YOU MAY BE ABLE TO get more starch for your money at McDonald's. Beginning next year, the fast-food chain hopes to start serving Big Macs in containers made of two cheap, abundant sources: potato starch and nestone. The technique comes from E. Khashoggi Industries (EKI), a think tank in Santa Barbara, Calif. EKI is granted an exclusive manufacturing license to EarthShell Corp., also in Santa Barbara. Barring production glitches, EarthShell and subcontractors hope to supply about 1.8 billion containers to McDonald's Corp. over a three-year period.

To make the containers, starch is boiled to a froth in water, mixed with some lime and wood fiber, and then baked into disposable bowls, plates, or cups in special molds. The containers keep their integrity as long as they remain relatively dry—meaning a container's water content must not rise above 20%. That's no big problem for burgers and fries. And to handle beverages, EKI has developed additional biodegradable coatings to keep a cup water-resistant until it is crushed or broken.

Per Just Andersen, EKI's vice-president for product engineering, says the starch containers should cost no more to make than paper, cardboard and polystyrene packaging, and require much less energy to manufacture. But the biggest advantage is environmental: Exposed to water in a landfill, the starch breaks down and is gobbled up by bacteria in far less time than it takes ordinary paper or plastic products to decompose. *Nellie Andreeva*

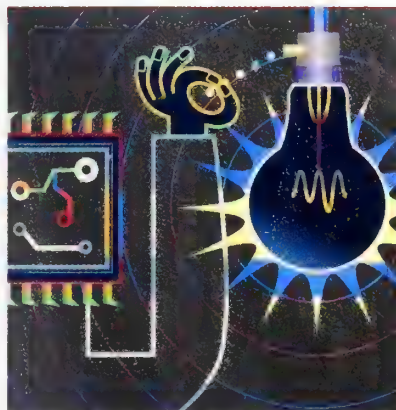
A CORK FOR LEAKY ELECTRONICS

THEY ARE CALLED VAMPIRES—ELECTRICAL appliances such as TVs, garage door openers, and battery rechargers that suck power even when not being used. The drain from such devices in U.S. homes alone adds up to 5 billion watts per year—roughly the output of five power plants, says energy leakage expert Alan K. Meier at Lawrence Berkeley Laboratory.

Chipmaker Power Integrations Inc. in Sunnyvale, Calif., has a new chip it says can cut up to 90% of the juice that flows into unused gear. The first target: AC adapters used to recharge cordless vacuums, cellular phones, and other appliances.

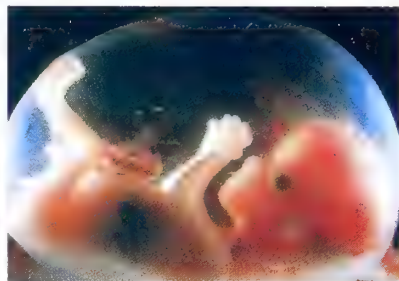
Power Integration's TinySwitch senses when adapters are inactive and shuts them down. With five to 10 such devices in the average home, yearly savings in the U.S. could exceed \$1 billion. Cell-phone giant Nokia Corp. plans to use the chips in future AC adapters for phones and other products.

The switch also could cut up to 30% of the juice guzzled by cable set-top boxes and some PCs when on standby. That could save \$1.2 billion more in wasted energy—and reduce carbon dioxide emissions by more than 20 million tons. With numbers like that, Power Integrations looks like a winner: Hambrecht & Quist analyst Gus P. Richard thinks the company's stock, now at 11, will nearly double over the next six months. *Andy Reinhardt*



GENE THERAPY: THE NEXT GENERATION?

DOCTORS HAVE DEvised a variety of therapies to correct genetic defects. So far, the effects have been confined to the cells of individual patients, never getting passed along to subsequent generations. But



biologists are now studying the next step, called germ-line manipulation. Eventually, this would entail altering genes in sperm and egg cells so that the fixes are inherited by the patients' children.

The National Institutes of Health will soon test public tolerance for such technology. The NIH is reviewing a re-

search proposal from gene therapy pioneer W. French Anderson at the University of Southern California School of Medicine in Los Angeles. His goal is to cure two diseases caused by genetic defects: a rare immune disorder and a type of anemia called alpha thalassemia. His team would begin by inserting new genes in fetuses of animals. Then it would consider applications to humans. Though Anderson wouldn't directly tamper with reproductive cells, some of the curative genes could pass into the germ line.

That disturbs people at the Council for Responsible Genetics, a watchdog group in Cambridge, Mass. On Sept. 18, CRG issued an "action alert" warning that the germ-line modifications implicit in Anderson's proposal could lead to manipulation of the human genome, raising the specter of eugenics. The NIH says it welcomes public debate and is holding hearings on the issue. □

INNOVATIONS

■ Radiation therapy is widely used to kill vagrant cancer cells after the removal of a brain tumor. Sadly, some cells usually survive. In order to make these renegades more vulnerable, scientists at the University of Pennsylvania Medical Center in Philadelphia are using drugs that attack a protein on the tumor cell surface called an erbB receptor. In *in vitro* and early animal experiments, the combined therapy produced kill rates as high as 60%, compared with just 5% for radiation therapy alone.

■ Wearable computers are looking good. Engineers at IBM Japan's Yamato Laboratory have crammed a 233-megahertz processor, a 1-inch disk drive, and a battery into a box the size of a Walkman. You move the cursor with a trackball or by spoken commands, and view the results on a tiny LCD in front of one eye. Products may be ready by 1999.

PART #325:

Asset Management



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STORY #7:

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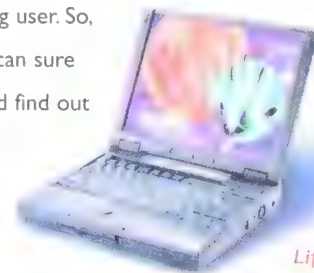
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MALONE: TV'S NEW UNCROWNED KING?

With Liberty Media, he'll run a programming juggernaut

Years back, when John C. Malone was building Tele-Communications Inc. into a cable giant—with mountains of debt and rising losses—he was known to face down creditors with a flamboyant ploy: Throwing his car keys down on his desk, the TCI chairman would tell visitors, “Here are the keys. You run this company.”

Finally, Malone has given his backers a big payoff, selling TCI to AT&T for \$48 billion. But this time, Malone—who will be AT&T's biggest individual shareholder, with 1.5%—is keeping the keys to his new deal-making machine for himself. Even while the lawyers haggle over the final wording of the AT&T deal, Malone has been focusing his attention on Liberty Media Corp., the separate entity that he created to house TCI's programming and noncable holdings. Although its assets will be owned by AT&T but traded separately as a “tracking stock,” Malone will be Liberty's chairman, with the right to name most of the members of its board, and Liberty will gain \$5.5 billion in cash on closing the AT&T deal.

BUZZ, BUZZ. Tongues in the media world are wagging about how Malone cut his sweetest deal yet, laden with concessions from the telephone giant. And the talk is almost as loud over what he'll do next at the helm of a programming juggernaut holding everything from big stakes in Discovery Communications, Time Warner, and USA

Networks to expanding partnerships with Rupert Murdoch's News Corp. “Kinda scary, isn't it?” says John Feltheimer, president of Sony Corp.'s television unit, which last year was part of a \$539 million deal with Liberty to buy control of Tele-

mundo Group Inc., the Hispanic television network.

Impressive, certainly. To get to the million cable subscribers TCI and its affiliates control as a platform for local phone service, AT&T agreed to leave Liberty with what Salvatore Muoio, managing partner at SM Investors LP in New York, estimates to be enough cash, liquid assets, and borrowing capacity to pursue a \$20 billion acquisition. Says Muoio, “It'll be one of the bigger pots of cash out there among media companies.”

FRONT BURNER. And make no mistake: Malone is plotting ways to spend it, even while he and fellow Liberty execs beg for interviews, citing the regulatory “quiet period.” Wall Street investment bankers say a move for a stake in General Electric Co.'s NBC, contemplated earlier this year, could soon be back on the front burner. Malone and his lieutenants are also openly enthralled with the coming generation of digital set-top boxes. They are pursuing deals for new services to be delivered over them, and they may also carve out a new niche leasing the boxes to cable and satellite operators. If Malone gets his way, he'll have an even more powerful hold over what people watch on TV than he did as a cable tycoon.

Meanwhile, Liberty is near closing a \$2 billion deal, through subsidiary United Video Satellite Group Inc., to acquire the TV Guide assets from News Corp. And United Video may yet again try to buy Gen-

star International Group Ltd., from which it launched a \$2.8 billion bid in June. The offer was pulled when the Pasadena (Calif.) on-screen programming guide company adopted a poison pill defense.

As with Gemstar and *Guide*, the deals that Malone wants to do at Liberty are focused on giving it either the technology or the brand name to play in the coming digital-TV age. In mid-September, Liberty paid \$5 million for a 10% stake in ACTV Inc., which owns technology that allows viewers to call up statistics about players involved in games they're watching or interact with other types of shows.

Meanwhile, Malone and Murdoch are expected to finalize in early October their \$700 million offer, through United Video, to buy a controlling stake in TCI's



ROYAL RANSOM

The TCI sale makes Malone AT&T's top individual shareholder, with 1.5%



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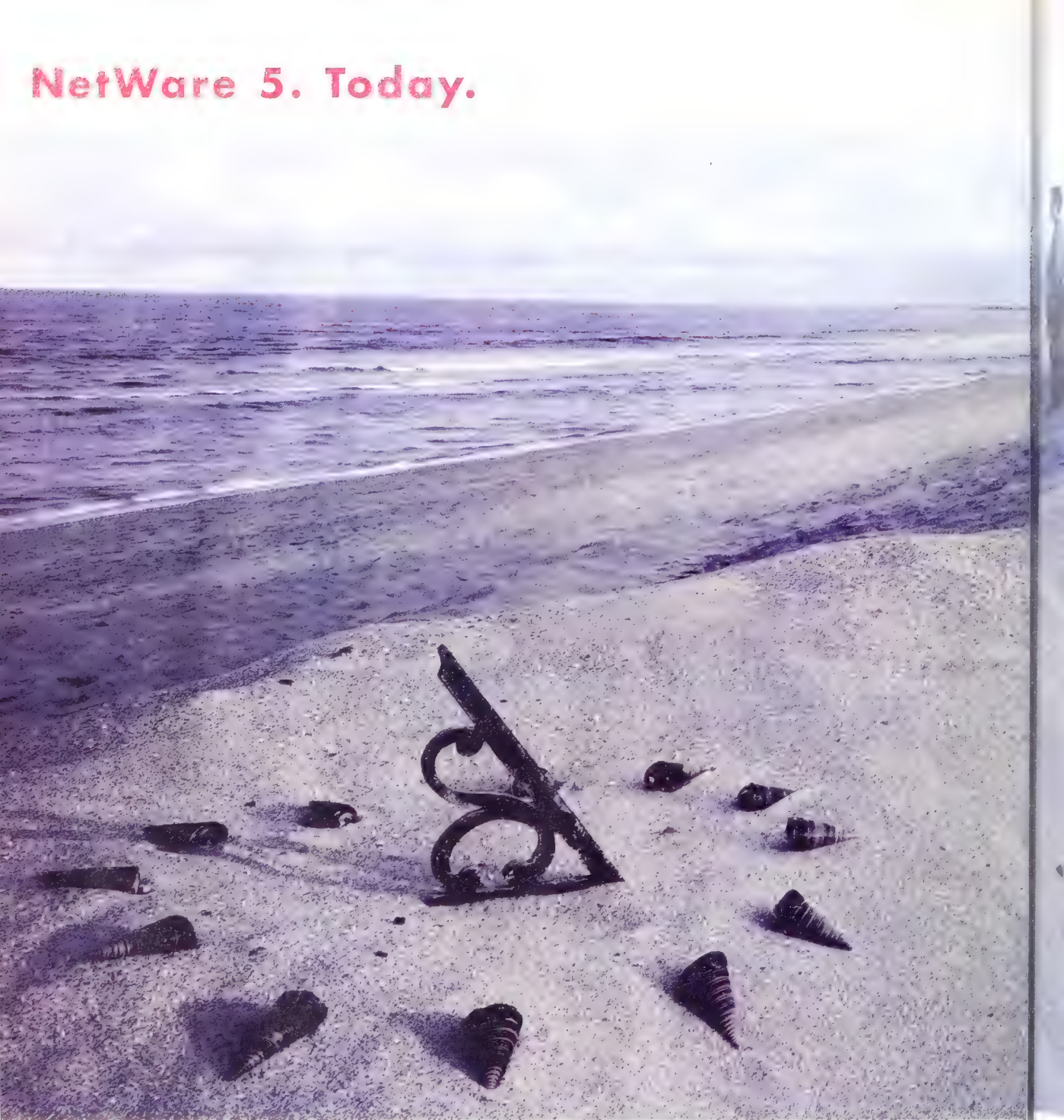
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NETWARE 5

The biggest question is whether Malone's maverick style will clash with the buttoned-down AT&T culture

Primestar Inc. direct-broadcast satellite service. In the future, says Lehman Brothers media analyst Larry C. Petrella, Malone is likely to find his favorite kind of deal—cheap—overseas, in troubled entities such as Germany's Kirch Group.

For all its financial muscle and its perch at the epicenter of a glamour industry, Liberty looks like little more than a mutual fund for programming assets: Only 14 executives rattle around its Englewood (Colo.) offices. Indeed, the bulk of the assets in Liberty's portfolio are operated day to day by such heavyweights as Ted Turner and Gerald M. Levin at Time Warner, John Hendricks at Discovery, and Barry Diller at USA. Says Ted Henderson, managing director of brokerage Janco Partners Inc. in Englewood: "The Liberty portfolio has assembled a group of executives that, if you believe in the future of content ownership, you want to invest alongside."

Malone may leave the programming to others, but he has made sure there's a home for all of his favorites. A key concession that he extracted from AT&T will give Liberty channels "preferred vendor status" on the existing TCI cable systems. That, claims John Tinker, an analyst at NationsBanc Montgomery Securities Inc., means "TCI's systems give him all but free channel space for as many as 12 channels in a third of the country."

BIG GAME. That makes bringing additional channels into the Liberty portfolio especially appetizing. The 49% stake in Discovery, for instance, is expanding through such new channels as the fast-growing Animal Planet and the recent purchases of the Travel Channel and part of CBS's struggling *Eye on People*. CBS is also looking for a partner for its Spanish-language news network, TeleNoticias, which could fit nicely with

Liberty's recent investment in Telemundo. Another long-rumored deal is a merger of Liberty's Encore pay-TV service with Viacom Inc.'s Showtime pay service—and Muoio speculates that someday Liberty could make a run at Viacom itself.

Other big game could include taking part or all of CBS or NBC, most likely through USA Networks, in which Liberty holds a 21% stake. At the moment, though, there's no deal being discussed with NBC, says USA Chairman and CEO

common shares. Malone's take: around \$1.8 billion, including Liberty shares worth about \$852 million. The biggest risk, however, is whether Malone's maverick style will clash with the buttoned-down AT&T culture. Wall Street sources cite AT&T Chairman C. Michael Armstrong's discomfort with Malone launching a hostile bid amid the merger dealings as one reason the Gemstar offer was pulled. And although both companies are quick to point out that AT&T did not acquire Liberty's

part of the TCI transaction—a "capital stock committee" made up of two outside AT&T directors at Liberty—Malone will oversee the AT&T/Liberty relationship.

As part of the merger deal, AT&T will give Liberty \$5.5 billion in cash and some of its existing assets, such as its stake in the cable online service Home Corp. Liberty also gets TCI's \$1.7 billion tax-loss carryforwards, and if it generates tax losses for AT&T, Liberty gets compensated from the phone company. Moreover, after years of near-junk bond debt ratings, Malone may try to use Liberty links with AT&T to borrow money at better rates. AT&T spokesperson stresses, however, that AT&T will not be helping Liberty borrow money.

Either way, it's little wonder that Malone has been gathering his top dealmakers, such as Liberty President Robert "Doc" Bennett, around him for the second act. Recently asked about how he finagled such a sweet deal, Malone feigned surprise and said

there's nothing in the new Liberty that he didn't already have at TCI. "Who's the bad deal for?" asks Malone. "AT&T is what they wanted." And, one way or another, so will Malone. After all, if for some reason AT&T decides to call off the marriage, it is still required to pay TCI a hefty \$1.75 billion breakup fee.

By Ronald Grover in Los Angeles and Richard Siklos in New York

Giving Him Liberty

Some of the assets that Malone will oversee as the chairman of Liberty Media

	OWNERSHIP	VALUE	COMMENTS
DISCOVERY COMMUNICATIONS	49%	\$2.9 billion	It's in the process of expanding retail stores and adding channels at home and abroad
QVC	43%	\$2.1 billion	A shopping network controlled by Comcast
USA NETWORKS	21%	\$2.1 billion	One possible acquisition vehicle for CBS or NBC
FOX SPORTS	50%	\$1.3 billion	Acquisition vehicle for more sports channels and teams
BLACK ENTERTAINMENT TELEVISION	34%	\$400 million	Just taken private, planning major brand extensions
TELEMUNDO	25%	\$88 million	Could be a vehicle for buying more Hispanic programming assets
TIME WARNER	10%	\$4.6 billion	Strategic foothold in world's biggest media company
UNITED VIDEO SATELLITE	44%	\$791 million	Pending a merger with <i>TV Guide</i> , acquisition vehicle for TV program guides and satellite broadcasting
TCI INTERNATIONAL	100%	\$3.3 billion	Acquisition vehicle to purchase international programming and cable assets

DATA: NATIONSBANC MONTGOMERY SECURITIES' BUSINESS WEEK

Barry Diller. Resumption will occur, Diller adds, "only if someone is going to offer us a great deal that we haven't seen so far."

True to form, the greatest deal Malone has cut is for himself. Already, AT&T has agreed to pay a 10% premium for the TCI supervoting shares, of which Malone owns the lion's share—on top of the 30% premium it is paying for TCI

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MINORITIES

INVISIBLE— AND LOVING IT

Black entrepreneurs find that the Internet's anonymity removes racial obstacles

Often, the slights seem incidental: Customers approach the white store clerk, assuming he's the owner. At other times, the comments Betty A. Ford hears at Mailbox Haven, her suburban Seattle package-delivery business, feel more racially pointed. She recalls one white customer who warned, "I'm going to watch you wrap my package," and another who asked, "Is this business black-

owned?" Well, yes, Ford thought. But why did it matter? Such patrons "assume I'm not in control because I'm black," she says.

Mailbox Haven thrives, but Ford wants to sell the operation. She's seeking her fortune now on the Internet, having launched City Boxers, an online retailer of hand-tailored boxer shorts. The product is a natural, filling an attractive niche geared toward the Net's large male audience. Just as important, in the Web's virtual reality, Ford has found some workplace solace. Shoppers "make their decision on what the boxer shorts look like, not on who's selling them," she says.

As President Clinton and his Race Initiative Advisory Board wrestle vainly with racial bias—what W. E. B. DuBois proclaimed the problem of the 20th century—the Net is providing some relief for the

21st. Hundreds of black and other minority entrepreneurs are setting up shop in cyberspace, many with impressive results. Though exact numbers are impossible to nail down, "there's a group of black folk that recognizes the potential to shatter the barriers that physical commerce creates," says Julianne Malveaux, an economist and author of *Sex, Lies and Stereotypes: Perspectives of a Mad Economist*.

COLOR-BLIND. It's an intriguing outcome of the Cyber Age. The Internet has been reviled for isolating Americans to their PCs, encouraging "virtual" communities at the expense of real ones. Cyberspace, moreover, has provided unchecked time and space for race-based hate diatribes. Yet in commerce, the Net's cool anonymity proves an advantage to minority business owners, allowing them to bypass real-life tensions by masking their racial identity. Just as important, Web-based businesses typically require far less capital than comparable physical operations, removing another historical hurdle for minority entrepreneurs.

That's no answer to racism per se, of course. But the Internet's color blindness does allow entrepreneurs to succeed, not, on their own merits. Re-



EASY FIT

By setting up City Boxers in cyberspace, Betty Ford has managed to do business while bypassing real-life racial tensions

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The low startup and operating costs in cyberspace also are a big boon for minority businesses

sevelt Gist Jr., a 51-year-old former car salesman, remembers white customers at a large Virginia dealership asking if they could speak to another salesman, clear evidence that his race was a turnoff. On the Net, the question is moot. Gist's four-year-old online service, a forum for buying, selling, and researching cars, gets 40,000 visitors a month—none of whom has a clue that he's black—and collects about \$200,000 a year in advertising revenue.

ple...to build a small business out of passion and interest, whereas before, the barriers were too high," says Barry Parr, director of E-commerce strategies for researcher International Data Corp.

Entrepreneurs can leverage such small investments by reaching instantly across global markets. Gigi Roane created drumandspear.com on retirement

bilt University. And black consumers are just as likely as whites to make purchases online.

More important, black entrepreneurs are moving past small consumer-oriented sites to discover business-to-business applications, which account for two-thirds of all online transactions. One key project: minority.net, an electronic

BREAKING DOWN BARRIERS ONLINE

The Internet's anonymity and low cost help minority entrepreneurs launch businesses. A few sites:

minority.net Once complete, this business-to-business site will host the largest minority E-commerce mall on the Web, with more than 100 companies. Supporters include Nexgen Solutions, IBM, the U.S. Commerce Dept., the Urban League, and the Asian American Business Development Center.

cyberstudy101.com A new site to help high school and college students prepare for exams has been a hit after less than a month. Since Sept 1, it has grossed \$6,000; it expects to generate \$4 million in its first year.

twmall.com This Asian-American mall does business in Chinese and English. After one year, it includes some 40 companies and has grossed more than \$120,000.

autonetwork.com One of the most complete automotive sites on the Web. It has classified ads, leasing information, broker services, advice columns, and scores of links. From startup money of \$6,000, the site now produces \$200,000 in annual revenues.

collard-cards.com This site sells greeting cards and cookbooks featuring upbeat black images. Sales in six months have totaled just \$500. ▶

While racial anonymity provides psychic advantages, though, the Net's crumbling of financial barriers is the bigger boon. Carolyn Louper-Morris, a former political science professor, first tried to launch Cyberstudy101 the traditional way, producing study aids on diskettes and shipping them to colleges. But that operation would have required \$2.2 million in investment to send 217,000 boxes to 58 universities a year.

GLOBAL REACH. Instead, Louper-Morris took Cyberstudy101 online, where its operating expenses are dramatically lower. Customers download materials directly from the Web site, so shipping costs have disappeared. The company's operating costs, limited mostly to marketing and Web site management, are expected to be \$65,000 the first year. "That's what made me move the product from land to line," says Louper-Morris, who says revenues should reach \$4 million. Many Web-based businesses are even cheaper to run, costing as little as \$100 a month and "allowing peo-

savings of \$5,000, offering access to black-oriented books that most mainstream bookstores don't carry. The online business quickly reached customers in Kansas, Oregon, and overseas, grossing \$170,000 in 1997 and persuading her to set up a small physical shop for local customers in her Washington home last year.

For a segment of ethnocentric black businesses, indeed, the Internet's vast reach is more compelling than its anonymity. Operations such as Roane's are explicitly race-based: They thrive by serving the Net's growing minority population. Some 5 million black Americans surf the Web, according to a recent study by researchers at Vander-

bilt University. And black consumers are just as likely as whites to make purchases online. More important, black entrepreneurs are moving past small consumer-oriented sites to discover business-to-business applications, which account for two-thirds of all online transactions. One key project: minority.net, an electronic mall set to be launched in mid-October by Nexgen Solutions Inc., Silver Spring (MD). Web-consulting firm with support from the Commerce Dept.'s Minority Business Development Agency and the National Urban League. Minority.net initially will link 75 small, minority-owned businesses with major companies, including giants such as IBM. By year-end, Nexgen hopes to have 500 minority companies exchanging goods and services with the behemoths—allowing a black-owned so-



ware consultant in the Midwest, say, strike a local consulting deal with IBM.

Ultimately, of course, black entrepreneurs on the Internet still need the same skills and products required to succeed in the physical marketplace. Yet the online world can help: It doesn't eliminate racism—but for some entrepreneurs, it does level the playing field.

By Roger O. Crockett in Chicago



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WHO CAN YOU TRUST?

Auditors, analysts, and earnings reports are supposed to help you. Too often they don't

With financial markets in Tokyo, Seoul, and Moscow imploding, investors are flocking to the U.S., where they know certain bedrock principles still apply. Here, companies adhere to universally accepted accounting standards. Auditors scour the books to keep management honest. Regulators ensure that "sunshine" is applied through regular disclosure. And analysts parse the numbers on behalf of investors for information that will make them money.

Or at least that's the way the checks and balances are supposed to work. But lately, questions have begun to be raised about the integrity of the U.S. financial markets, too. Nothing on the order of what has been happening overseas, of course, but disturbing questions nonetheless.

The concern is being driven not just by accounting obstacles, as witnessed at Cendant Corp. It's the gnawing sense that companies that should know better are regularly pushing the limit, accountants are AWOL, and analysts are too enmeshed with their investment-banking brethren to provide ob-

jective advice. Even investors bear some responsibility: They've been so eager to cash in on the bull market that they've frequently ignored or optimistically interpreted restructuring charges, acquisition write-downs, and other accounting ploys that camouflage what's really going on.

As risk has returned to the system with a vengeance, smart players are starting to apply more discrimination. Savvy institutional investors are seeking more independent analysis. Regulators are stepping up the public pressure on companies and accountants. Companies that shun accounting convention are being punished in the marketplace. And individual investors, singed by unpleasant surprises, are starting to educate themselves. Of course, the pressures that caused these problems to arise in the first place are not going to disappear quickly. And with markets as volatile as they are, no issue deserves more attention.

BUSINESS WEEK devotes this Cover Story to examining the depth of the problem, identifying solutions, and educating investors in self-defense.

By Sarah Bartlett

Cover Story

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EARNINGS HOCUS-POCUS

How companies come up with the numbers they want

When America Online's management put together its quarterly financials early this summer, it was with some measure of pride, says new Chief Financial Officer J. Michael Kelly. Indeed, the results were remarkable. AOL would be posting a 900% rise in operating profits, to \$57 million. At 23¢ per share, earnings would handily beat Wall Street's estimate of 19¢.

The excitement didn't last long. Soon, the Securities & Exchange Commission's officials began peppering the company with inquiries. Their beef, according to AOL: the company's plans to use a controversial accounting technique to instantly write off much of the value of two companies it had just purchased. By taking a charge for "in-process R&D" under way at the companies, AOL figured it could write off fully \$20 million of the \$29 million it was paying for NetChannel, an Internet television company, and a "substantial portion" of the \$287 million it would pay for Mirabilis, a developer of real-time chat software.

The SEC appears to have found the size of the charges trou-

bling, however, and by Aug. 4, the date of AOL's fourth-quarter earnings release, the issue hadn't been resolved. So Kelly did something rarely seen in Corporate America: He announced quarterly results that didn't go to the bottom line.

There was simply no way to calculate net income without the SEC's blessing on the charges. "We had such phenomenal operating results," says Kelly. "To hold that back for an unfinished accounting matter didn't seem appropriate." Investors didn't take the matter so lightly. In two days, they dumped 23 million shares, sending the stock down 5%.

AOL ought to have known better. After all, it's not the first time the company's accounting practices have been ques-

Accounting Tricks of the Trade

IN-PROCESS R&D CHARGES Taken by the buyer at the time of an acquisition, these charges represent the estimated value of R&D at the purchased company. Because it is still "in process," the research is not yet commercially viable. Since it may prove worthless, it can all be written off. But by separating the expenses from revenues that might be gained in the future from the R&D, future earnings can get a big jump.

POOLING A method of accounting for mergers and acquisitions that eliminates goodwill charges. All assets and liabilities of the companies are combined at book value, so there's no goodwill to depreciate. That boosts earnings, one reason use of pooling has exploded.

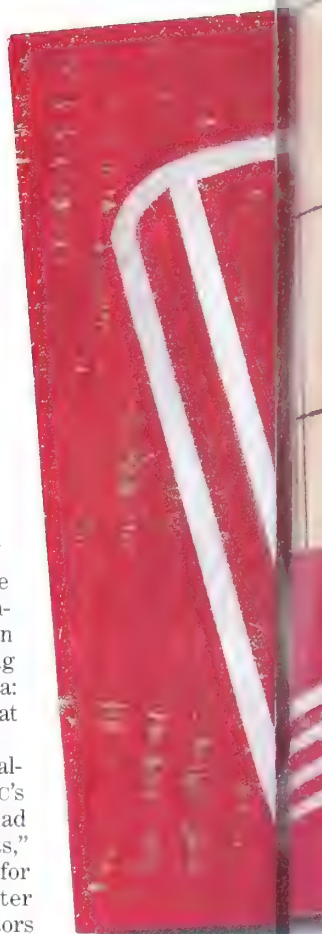
RESTRUCTURING RESERVE Created by combining several years of expected future expenses and writing them all off at once as an "extraordinary" one-time charge. This jacks up future earnings.

REVENUE RECOGNITION How quickly or slowly revenue is booked. It is especially important in industries such as software, where service contracts and upgrades can stretch revenue out for years. Booking revenues too early provides fertile ground for inflating sales and earnings.

tioned. In 1996, after dubious investors challenged its policy of writing off marketing expenses over two years, AOL restated its numbers in a move that erased all its previous profit overnight. But a company that once might have been dismissed as a rogue is now just one face in a troubled crowd. Across Corporate America, a wave of concern is rising about the quality of corporate earnings—and the tactics companies are using to calculate them.

Headlines this summer have been dominated by spectacular cases involving allegations of outright accounting lies: Cendant Corp. accuses some former executives of fraudulently inflating income before charges by \$500 million over three years, in large part by booking fictitious revenues. Livent Inc. allegedly kept two sets of books to mask extravagant expenses.

But forget about fraud for now. Regulators and investors are starting to focus on a far broader problem: companies bolstering their performance by using every legal accounting game in the book. They appear to be exploiting opportunities to jazz up their earnings like never before—all without stepping outside the loose con-





nesses of generally accepted accounting principles (GAAP).

That has led to a slew of spectacular collapses of companies caught playing fast and loose with their numbers. Investors in such onetime highfliers as Green Tree Financial, Waste Management, and Sunbeam have seen years of seemingly solid earnings vanish overnight. The culprit: overly rosy or misleading information about sales or expenses sometimes buried deep within their financial statements.

BIG BATH. And that's only one part of the problem. SEC officials are also worried about the abuse of huge, virtually unrestricted "big-bath" write-offs. Indeed, write-offs such as Motorola's recent \$1.98 billion restructuring charge have become all too common. Even that is small change compared with the multibillion-dollar charges taken by high-tech acquirers such as Compaq Computer Corp. and WorldCom Inc. write off "in-process" research when they close a deal. Meanwhile, others have taken so many "extraordinary" charges year in and year out that the only thing truly out of the ordinary is a year without write-offs.

Of course, companies have always taken write-offs and restructuring charges. But nervous regulators and investors fear that such huge multiyear write-offs are increasingly distorting corporate earnings—so much so, in fact, that some question whether the underlying meaning of profit numbers is their value as a true reflection of corporate performance is getting trampled.

To understand why, remember what the earnings number is supposed to represent: an accurate snapshot of how

well a company's operations performed in a given year. And one of the basic principles of accounting is that both revenues and costs should be matched to the year in which they occur. Otherwise, managers have too much leeway to massage the numbers, and "annual" performance becomes meaningless.

But the aim of many of today's giant write-offs is to front-load expenses. Charge off three years of expenses all at once, and by definition future earnings will be better. It's akin to making three years of mortgage payments at once, then claiming your income has grown.

Fueling the trend is the fact that stock traders tend to ignore big "one-time" charges, focusing instead on prospects. So even if the total dollars spent are the same, companies have a far greater incentive to take one large charge rather than stretch expenses out as money is actually spent. Indeed, the market's reaction encourages executives to make charges as big as possible. And that's got investors and the SEC worried that companies are burying all sorts of normal operating expenses into their restructuring charges. "Somebody woke up to the fact that if you take something as a restructuring charge, investors will forgive you immediately," says Robert S. Miller, the nonexecutive chairman brought in to clean up Waste Management. "We've almost lost the no-

Cover Story

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addition, WorldCom is conducting asset valuation studies of MCI's tangible and identifiable intangible assets, including in-process research and development projects, for the purpose of allocating the purchase price to the net assets acquired. A preliminary estimate of the one-time charge for purchased in-process research and development projects of MCI is between \$6 and \$7 billion. This

THAT'S SOME PRICEY R&D

► After WorldCom's \$37 billion deal for MCI, investors had to dig deep into the footnotes of WorldCom's second-quarter 10Q filing to discover it planned to take a \$6 billion to \$7 billion charge against earnings for R&D under way at MCI. By writing off "in-process research" as a one-time charge rather than writing it down as goodwill over 40 years, WorldCom will boost its income by at least \$100 million annually for decades to come.

tion of what are earnings and what are one-time charges."

Why are so many questions about the quality of earnings arising now? For one, there's a mismatch between today's deal-oriented, high-tech economy and a decades-old accounting system in which only "real" assets such as bricks and mortar can be easily valued. Throw in an eight-year bull market in which earnings growth came to be the only measure many investors looked at, and add the pressure those market forces have created on managers to make the numbers look as good as possible. If anyone had set out to invent a system in which the means, motives, and methods to encourage companies to stretch earnings all came together perfectly, they couldn't have done a better job.

But with the economy slowing and Wall Street jittery, concerns are growing that companies desperate to keep up

Cover Story

WHO CAN YOU TRUST?

Cook, chairman and CEO of Deloitte & Touche: "As economic pressures get tougher over the next 3 to 12 months, I worry whether the system will measure up."

MORE DISCLOSURE? He's not the only one. On Sept. 28, SEC chief Arthur Levitt will give a speech at New York University outlining plans to improve the accuracy of earnings. "We have become concerned that the quality of financial reporting is eroding," Levitt says. In recent weeks, the SEC's new chief accountant, Lynn Turner, has met with officials of Big Five accounting firms, Wall Street analysts, and CFOs to discuss concerns. "If the basic accounting foundation ever loses credibility with investors," Turner says, "then the whole [investing] process would fall apart."

The SEC won't say what steps it plans, but it may require more disclosure about restructuring reserves and the valuation of R&D write-offs. It's also concerned about how companies account for mergers. Talks on mergers and restructuring charges are also under way at the Financial Accounting Standards Board (FASB), an industry body chartered by the SEC that created and updates GAAP. But any

earnings and stock prices will practice even more aggressive accounting. Warns J. Michael

FASB-driven changes could take years to iron out

Of course, not every accounting charge reflects management efforts to fool investors. In many cases, the charges reflect real operating problems. Some experts argue, too, that in some ways the earnings picture is actually clearer today. Gabrielle Napolitano, an accounting analyst and portfolio strategist at Goldman, Sachs & Co., points out that low inflation has improved accounting for inventory and depreciation expenses.

Still, what's troubling is that massive charge-offs have been wiping out earnings at a time when the economy is booming. According to earnings-watcher First Call Corp., the number of companies taking restructuring charges jumped from 96 in 1995 to 230 last year. And despite a then seven-year-old expansion, companies in the Standard & Poor's 500-stock index wrote off \$7.04 a share in earnings in 1997, topping the previous high of \$6.61 in 1993, when Corporate America was struggling to dig out from the lingering effect of a recession. Fueled by merger-related charges, the S&P companies wrote off fully 17.7% of their earnings last year—more than triple the 5.6% Napolitano predicted at the year's start.

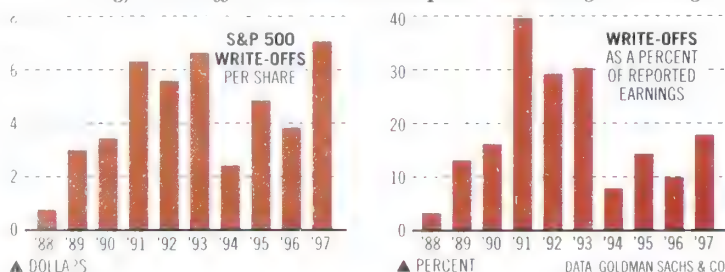
That's why the manner in which companies handle big write-offs is far from an arcane accounting debate. They can significantly alter the earnings picture investors see. Consider the case of Lucent Technologies Inc. As part of the process of Lucent's spin-off from AT&T in a 1996 public offering, the company took a big-bath charge in which it set up a \$2.8 billion reserve to cover restructuring costs. To come up with the figure, the company in late 1995 estimated how much the restructuring would cost over several years. Lucent's reserve was to cover severance for 20,000 employees and the cost of exiting businesses such as AT&T's Phone Center Stores.

So far, so good—and there's where the first benefit comes in. By writing off several years' worth of costs at once rather than taking them each year as the money is spent, Lucent eliminated future costs from its books. It's a common practice—and one that automatically improves earnings down the line.

The gains didn't end there. As it turned out, Lucent put aside far more than was needed to cover the restructuring

Earnings: Now You See 'Em, Now You Don't

All-time record write-offs have wiped out a huge chunk of reported earnings. Though things aren't as bad as the early '90s, there is a key difference. The earlier write-offs came amid recession; more recently, write-offs have soared despite a booming economy.



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OAK BROOK, Ill., July 20 -- McDonald's Cr

	Six months ended June 30		Quarters ended June 30	
	1998	1997	1998	1997
Other operating (income) expense -- net				
Dollars in millions				
Gains on sales of restaurant businesses	\$ (22.0)	\$ (27.6)	\$ (14.0)	\$ (20)
Equity in earnings of unconsolidated affiliates	(34.4)	(33.2)	(22.0)	(17)
Special charges	350.0	5.5	350.0	(12)
Special charges expense	48.0		29.9	(12)
			242.9	\$ (49)

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended June 30, 1998

Occupancy costs		11
Selling, general, and administrative expenses	25.2	8
Special charge	26.7	4
Other operating (income) expense-net	160.0	(N/M)
TOTAL OPERATING COSTS AND EXPENSES	51.9	(N/M)
OPERATING INCOME	603.7	15
	(69.2)	(5)

ONE-TIME CHARGE OR ONGOING EXPENSE?

► On July 20, McDonald's announced a \$350 million restructuring charge, which included \$190 million to install new cooking equipment. Shouldn't upgrading kitchens be a normal operating expense in the restaurant business? The SEC appears to think so. After it questioned the charge, McDonald's reversed it and lowered its special charge to \$160 million. Booking the costs as it actually spends the money will cut an estimated \$25 million to \$35 million from earnings each quarter through 1999.

ing expenses—and the excess reserves have since helped the company smooth out what might otherwise have been much choppy earnings. One reason for the excess: The booming economy helped lower Lucent's costs as former employees quickly found new work. So Lucent converted some of its restructuring reserve back into income. Over three years, it took \$382 million from reserves and added it back to pretax income.

Cover Story

WHO CAN YOU TRUST?

Thus, even as the reserve cut expenses, Lucent's income got a big boost, too.

Lucent has also benefited from an accounting technique that's becoming wildly popular among high-tech companies—while drawing increased scrutiny from the SEC. As Lucent bought companies over the past two years, it wrote off \$2.3 billion of in-process research and development. That figure—Lucent's estimate of the future value of R&D at the companies it bought—has allowed Lucent to avoid \$2.3 billion in "goodwill." That's an accounting term for the premium paid for a business or asset above the value recorded on its books, which would normally have to be

written off as an expense over many years.

Now, it's worth emphasizing that everything Lucent has done has been found to be in accordance with GAAP by its auditors, PricewaterhouseCoopers. The SEC has not challenged one of these moves. The company's filings and press releases clearly disclose exactly what it is doing. Indeed, every decision was made under the "letter and intent of the law," says controller James S. Lusk. "I don't believe in accounting cocaine." And Wall Street certainly likes the results: Lucent's shares have outperformed the S&P by 25% since its IPO.

But the question remains: What if Lucent hadn't taken a one-time charge but spread restructuring costs over the years it took to clean up? And what if the reserve had been written off over

years, a typical period?

The answer, according to Jack T. Ciesielski, a well-known accounting expert and money manager, is that Lucent's books would have reflected a much less smooth but possibly more accurate picture of management's ability to drive growth. Using the numbers Lucent reported

in its SEC filings, Ciesielski first eliminated the effects of the restructuring reserve. Instead, he treated the expenses as normal costs in the years they occurred. Then, he eliminated the income created by the reserve reversals and calculated what goodwill would have been without the R&D write-off. Along the way, he assumed all acquisitions came at the start of the year, and he used the corporate tax rate Lucent paid each year.

How do his figures compare with Lucent's operating income—net profits excluding special charges—the number that investors most closely watch? He calculates that in 1997, Lucent would have lost \$49 million rather than its \$1.05 billion operating earnings gain. Earnings last year, he figured, would have been a modest \$1.11 billion, well below Lucent's \$1.51 billion. And for the first three quarters of fiscal 1998, Lucent would have made \$1.51 billion, \$229 million less than the \$1.74 billion it reported. "The reason managers love these [moves] is that they buy them time," says Ciesielski, publisher of *The Analyst's Accounting Observer*. "You wouldn't have a stock trading at the multiple Lucent is if they hadn't had this time to work all this out."

Lucent declined to comment on Ciesielski's analysis, saying through a spokesman: "To speculate or hypothesize about 'what if' scenarios when we adhered to strict accounting standards is simply not meaningful or productive."

So how can there be such disagreement over how to crunch the numbers? One culprit is an accounting system that many find obtuse and out of touch with an economy that is increasingly driven by technology and deal-making. The gray areas in GAAP are plentiful, and its terminology can be hard to define. What constitutes a legitimate "one-time" charge, and how does it differ from the normal operating costs of doing business every quarter? GAAP offers few clues. Some vital intangible assets, such as the brainpower of a team of micro-

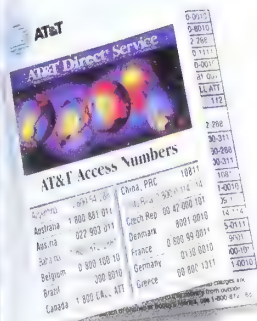


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NEW WATCHDOG: SEC accounting chief Turner has met with Big Five executive

chip designers, aren't measured at all. Other intangibles, such as patents, are valued by appraisal—a type of educated guess that is far from foolproof. Concludes Lawrence Revsine, a prominent accounting professor at Northwestern's J.L. Kellogg Graduate School of Management: "Accounting stinks."

One of the best illustrations of the mismatch between yesterday's accounting system and today's economy is seen in the exploding use of those R&D write-offs. Virtually unknown a decade ago, they have soared since IBM successfully used the technique to write off much of the cost of its 1995 acquisition of software maker Lotus Development. Today, such charges can reach billions of dollars.

To see why they're so popular, check out the payoff in WorldCom's \$37 billion purchase of MCI Communications Corp. WorldCom estimates

that MCI has R&D worth \$6 billion to \$7 billion under way but not yet ready for commercial application. Since WorldCom may never see any benefit from that R&D—conceivably, it could all come to naught—accounting rules allow WorldCom to write it all off at once.

Does that mean MCI was really only worth \$31 billion? Not necessarily. The real significance of that number lies elsewhere. Normally, any premium paid over "book value" would be called goodwill, which WorldCom would have to depreciate. Since that would cut into expenses for years, acquirers generally want to keep goodwill to a minimum.

Now here's where things get good. Since every dollar WorldCom can assign to in-process R&D is one less it has to call goodwill, it has every incentive to make the charge as big as possible. And acquirers have enormous leeway in valuing R&D. That's what really has the SEC worked up. It fears that companies are overstating these charges. Moreover, as with all front-loaded charges, writing off all R&D costs today will likely give future earnings a boost. When WorldCom actually turns some of that R&D into salable products, its earnings will look far juicier than they would have otherwise.

Gary Brandt, WorldCom's chief of investor relations, defends the treatment. But he concedes that if the charge were considered goodwill, WorldCom earnings would be cut by a min-

imum of \$100 million a year, or 5¢ per 1.9 billion shares outstanding. If the SEC doesn't challenge the charge and it isn't reduced by WorldCom, it will be the largest in-process R&D write-off ever.

But the potential to inflate research costs isn't the SEC's only worry concerning write-offs. Some of these charges can also provide cover for ongoing operating costs that should be booked as they occur. McDonald's Co. got its hand slapped for just such a move in August. The hamburger vendor elected to take all at once a \$190 million charge for the cost of ditching old grills and ovens and installing new ones. But the SEC disagreed that these charges were a one-time extraordinary cost. After all, if upgrading kitchen equipment isn't a normal cost of doing business for a restaurant chain, what is?

HOOKED. After discussions with the SEC, McDonald's decided to take the expenses as they are incurred. The company says it was not attempting to boost earnings by taking the one-time charge. Still, the shift will chop \$25 million

to \$35 million a quarter from earnings through late 1997, estimates Merrill Lynch & Co. analyst Peter Oakes.

If companies get away with them, such charges can become addictive. Kellogg, AT&T, and General Motors have all taken a remarkable number of restructuring write-offs this decade—leading critics to question how "extraordinary" they are. For a clear picture

CONCERN "If the basic accounting foundation loses credibility with investors, the whole process would fall apart"

of the benefits a company can derive from repeated write-offs, look no further than Eastman Kodak Co. Since 1991, Kodak has taken six extraordinary write-offs totaling \$4.5 billion. That's more than all of its net profits for the past nine years.

Kodak has been in a major transition period, exiting its major business lines as sales have dropped 25% since the write-offs began. Still, critics point out that Kodak managed to report operating earnings throughout that period—hinting the repeated need for such extraordinary charges implies that those operating figures may have been of little value. "Charges after charges after charges—that says Kodak overreported earnings," says David W. Tice, publisher of *Behind the Numbers* and manager of the Prudent Bear Fund, which invests in undervalued stocks. Kodak declined to comment.

Meanwhile, the SEC is also taking a close look at another corporate addiction: merger mania. Some \$1.2 trillion worth of deals have been announced already this year—greater than all of 1997—and as many as one-third would not have been done without the in-process R&D charge or a technique known as pooling-of-interest accounting, says Stephen S. Smith, managing director at investment bank Broadview Associates. Pooling lets companies combine their assets at book value, eliminating goodwill. Miller estimates that when USA Waste S-



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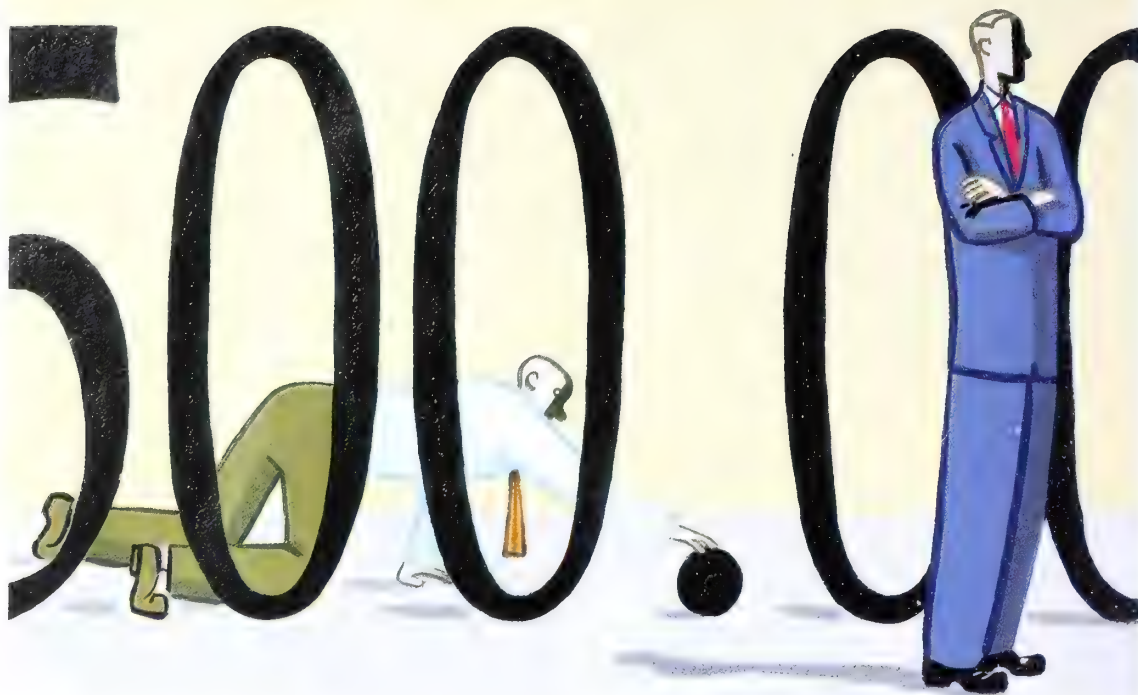
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WHERE ARE THE ACCOUNTANTS?

Why auditors end up missing so many danger signs

It read like a primer on how to cook the books. In letters to the board of directors of Aviation Distributors Inc. and the Securities & Exchange Commission a year ago, the company's auditors, Arthur Andersen, wrote of sweeping irregularities. The allegations included falsified shipping documents and purchase orders—problems so great that Andersen could no longer attest to the accuracy of three earlier years of Aviation Distributors' financial reports.

Andersen resigned from the account. The move set in motion a quick chain of events, from the delisting of the \$39 million company from the NASDAQ Small-Cap market (it's now traded over the counter) to the resignation of President and CEO Osamah S. Bakhit.

It all seems so straightforward—a perfect example of the role accountants are supposed to play in keeping the financial system honest. The problem is, it doesn't seem to happen as often as it should. As one apparently prosperous company after another saw earnings crumble in the wake of an accounting scandal over the past year, the auditors—at least in their public statements—often acted as surprised as investors to see years of previously reported profits go up in smoke. None of the major firms has emerged unscathed.

To take just one of the headline screamers, how did auditor

Andersen miss the red flags at Sunbeam Corp. last year, when inventories began piling up and accounts receivables soared? Chief Executive Albert Dunlap had never been exactly reticent about his desire to do all he could to keep his high-octane stock levitating. So shouldn't someone have noticed when the company reported surging sales of heating blankets in the summer and barbecue grills in the late fall?

Yet at a board meeting on June 9, a partner at Andersen assured Sunbeam directors that the 1997 numbers complied with standard accounting procedures. Four days later, the scheme unraveling, Dunlap was fired. Sunbeam later acknowledged it was booking sales before the goods were actually delivered to stores. Today, the SEC is investigating Sunbeam's accounting. The company is expected to restate results for part of this year, 1997, and perhaps 1996. Andersen says it doesn't comment on clients.

Unfortunately, auditors seem to have allowed more and more of their clients to undercut the trustworthiness of the reported numbers with aggressive, albeit often legal, accounting for everything from restructuring or acquisition write-offs to the way sales are booked.

"WITHIN THE RULES." Certainly, no one would argue that auditors face an easy task. And give them their due: Auditing firms are resigning more accounts than ever, according to *Public Accounting Report* newsletter. And much of the problem stems from the fact that those generally accepted accounting

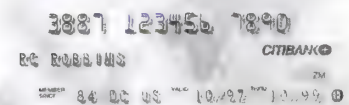
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principles give management wide latitude in how it puts together the books.

Consider what auditors suggest is an altogether typical set of circumstances leading to aggressive accounting. Executives face missed earnings expectations or a tight bank-lending covenant, and their bonuses hang in the balance. Suddenly, environmental or other legal liabilities are minimized, or inventory depreciation gets stretched out, or a big push is made to drum up end-of-quarter sales.

If the company's competitors pursue similar practices, executives are prone to ask auditors to follow the leader: "Everybody's doing it" becomes the rule—or the excuse—as lowest-common-denominator accounting takes hold. Rather than pushing their clients to uphold higher standards, accountants sometimes acquiesce in a race in which those most willing to stretch the rules define the industry standard. The bottom line: Too often, auditors "opine on what is acceptable, not what is appropriate," says Katherine A. Schipper, accounting

professor at the University of Chicago Graduate School of Business.

Sure, there is a

raft of industry requirements to detect fraud. But auditors sometimes have resisted some past efforts to toughen standards. An industry panel recommended four years ago that accounting firms not just verify that numbers meet GAAP requirements but that they go a step further and flag a company when its disclosures and estimates are aggressive. But the idea has been only "minimally" embraced by companies and auditors, says Donald J. Kirk, executive-in-residence at Columbia University and former chairman of the Financial Accounting Standards Board, who led the panel.

FOOT IN THE DOOR. Those tendencies clearly have the Securities & Exchange Commission worried—and there are indications that the agency is determined to force changes. Spurred by the recent bookkeeping disasters, the SEC is sending a message that it expects more from the Big Five auditing firms—Andersen, Ernst & Young, Deloitte & Touche, Price-waterhouseCoopers, and KPMG Peat Marwick. In recent meetings, regulators have warned partners that as the economy slows, corporations will be under even more pressure to stretch rules to meet their earnings numbers. The fear is management will "build more optimism into financial reporting, and they want us to make sure we are appropriately tough," says Deloitte Chairman and CEO J. Michael Cook.

But the SEC's concerns go much deeper than that. Top agency officials, as well as some corporate directors and investors, worry that the explosion of nonauditing services at the Big Five, such as general consulting and merger advisory work, might create an incentive to go easy on auditing clients. Nonauditing services now make up more than 50% of revenues at the Big Five, according to *Public Accounting Report*. As the SEC's top accountant, Lynn Turner, puts it: "When an audit partner at a major firm is faced with a tough decision, can the

partner make that decision based solely on his or her judgment about what is best for investors, without worrying about the impact on career or compensation?"

A year ago, the SEC signaled its concern by pushing for the formation of the Independent Standards Board. Made up of auditors and outsiders, the ISB plans to issue guidelines and rulings to help the industry police the conflicts created by its nonauditing business. Senior partners readily admit that auditing is intensely price-competitive and often serves as a wedge to get in the door to sell other products. But they deny that standards have suffered and say firms have safeguards to protect auditors' autonomy. Says Gregory A. Jones, Andersen's managing director for financial statement assurance: "It's important that it's understood that those who stand up to pressure are rewarded as much as those who bring in new clients."

Another concern for regulators is the coziness that can develop between auditors and their clients. For reasons of career diversification and pay, many auditors switch over to the corporate finance staffs of their old clients. Corporate books end up being audited by the executives' former partners. Robert Miller, who was brought in to clean up a mess at Waste Management Inc., believes that may have been one factor behind the alleged accounting irregularities that led the company to restate six years of earnings downward by \$1.75 billion. Many finance executives had come from Andersen, he says, creating "too much of a close relationship between senior auditors and senior managers."

The Big Five try to head off those problems by rotating partner off an account every seven years and having a second partner, not involved in the audit, sign off on each account. But auditors will need to do more if they hope to regain investor confidence. Corporate boards could go a long way toward helping by making sure audit committees consist of truly independent businesspeople. Critics suggest having companies disclose how much of an audit firm's fees are for nonauditing work. "Let the public know whether the audit is the dog or the tail," urges accounting analyst Abraham J. Briloff.

There are signs that the increased scrutiny—plus fear of lawsuits—is pushing the Big Five to step up their vigilance. Andersen will soon institute a scale for spotting fraud or over-aggressive accounting—for example, comparing market earnings expectations with management's ability to meet them. Already the firm is encouraging auditors who spot oddities such as unsupported journal entries to dig for deeper problems. "You find out these things are like cockroaches: If you see one, you're reasonably sure there are others," says Jonas.

But as long as corporate managers continue to look for ways to stretch the numbers, more problems are inevitable. "Investors have to understand that the safety net a clean-audit opinion provides can have loopholes," warns Lawrence Revsine, an accounting professor at Northwestern University. Still, investors should expect better—from auditors and from the managers and board members who employ them.

By Richard Melchiorre in Chicago

Cover Story

WHO CAN YOU TRUST?

Fixing the System

REGULATORS Tighten accounting principles to limit wide range of management discretion. Determine whether auditors' expansion into consulting and advisory services leads to conflicts—and if so, restrict it.

AUDITORS Pass judgment not just on whether numbers meet accepted principles but also whether management is stretching dangerously. Make sure auditors who just say no to clients are rewarded as well as those who bring in new business.

AUDIT COMMITTEES Stay independent of management. Meet regularly and alone with outside auditors to seek straight answers on internal controls and management integrity.



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WALL STREET'S SPIN GAME

Stock analysts often have a hidden agenda

Met Thomas K. Brown, 39, a Master of the Universe in bank stocks: 15 years on Wall Street and in eight of the past nine years, the top-ranked analyst of regional banks on the prestigious *Institutional Investor* All-America Research Team. On Mar. 25, after seven years at Donaldson, Lufkin & Jenrette Inc., Brown was fired.

Cover Story

WHO CAN YOU TRUST?

His sin? He was an outspoken critic of banks that had paid heavily to amass huge empires without much to show for it. Says Brown: "I believed many of the acquisitions are destroying shareholder value." Brown's bluntness and independence had become a problem for DLJ, which in recent years has tried to break into investment banking's top ranks. In fact, just hours before Brown's firing, the firm hired a team of two dozen investment bankers to help the firm arrange deals in the financial-services

industries. "I heard from my colleagues that the new investment bankers wanted me out," says Brown. "I was viewed as being negative on mergers and acquisitions."

Brown, who now runs a bank-stock portfolio for hedge-fund manager Tiger Management Corp., says DLJ offered him \$450,000 for a five-year agreement not to talk about the firm. He declined. A DLJ spokeswoman said ex-employees who ask for or get more than the typical two weeks' severance package are always asked to sign a "nondisparagement agreement, a common practice on the Street. As for the dismissal, Research Director Susan L. Decker says it resulted from "a longstanding and acrimonious conflict with colleagues in the institutional-equities division. It had nothing to do with any other department in DLJ."

Whatever the reason for the dismissal, Brown's unvarnished analysis will be missed. Indeed, analysts who try to provide a honest and unconflicted opinion are becoming scarcer and scarcer on Wall Street. If there ever was a time when it



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vestors could use straight talk, it's now. A runaway bull market glosses over a multitude of analysts' sins. But in today's unforgiving market, probing analysis and intellectual honesty can make the difference between plump profits and gut-wrenching losses.

The question for investors is: "Can you trust your analyst?" Unfortunately, the answer is not very much. At the major Wall Street houses, which thrive on investment banking, every analyst has a potential conflict of interest. The "Chinese Wall" that on paper still separates a firm's analysts from its investment bankers continues to crumble as analysts are encouraged to scout deals. The analyst's firm is either the investment banker for a company he or she is covering—or it's wooing the company for a piece of that juicy revenue stream.

A study co-authored by Georgia State University assistant professor Siva Nathan looked at reports on 250 companies by analysts whose firms had investment-banking ties with those companies and an equal number from analysts with no ties. The investment bankers' analysts had 6% higher earnings forecasts and nearly 25% more buy recommendations.

"TRAPLINE." Even when a firm isn't big in investment banking, its analysts often pull their punches. They shy from saying things that might anger a company's management, fearing loss of access to executives, company meetings, and earnings "guidance" chats—critical to making profit forecasts.

By and large, those estimates do little more than parrot the company line. Consider that over the last 20 years, the range of analyst estimates for the average stock has narrowed from 8% to 4%, according to I/B/E/S Inc., which collects and distributes earnings estimates to the Street. That suggests that the analysts are doing less original work and hewing closer to the company source. When earnings disasters hit—Cendant, Oxford Health Plans, or Sunbeam, to name a few—most analysts are as surprised as everyone else.

Institutional investors look at the analysts the same way polls show Americans think of members of Congress. Low opinion of most, but high regard for a select few. "Maybe 20% are intellectually honest," says Richard Strong, chairman of Strong Funds, with \$32 billion in assets. "And you assemble a trapline from them and try to replace those as they leave or retire."

Patrick Adams, who manages \$2 billion for Berger Funds, says much of what Wall Street analysts do is of little value to institutional investors, whose in-house analysts nowadays have as much access to companies. "Few go out and do independent investigations of talking to suppliers, customers, and competitors to determine what's going on," says Adams. He recently hired a market-research firm to "get something other than what the companies and the analysts are saying." And he also contracted with accounting sleuth Howard M. Schilit "to be the policeman on our portfolio," trying to identify companies with accounting-related problems before they blow up.

Analysts routinely play up good news and sugarcoat the bad. Positive corporate news—an unexpectedly strong earnings re-



FIRE: Ex-Donaldson Lufkin analyst Thomas Brown

port or successful product launch may get a recommendation "strong buy." Bad news gets "hold" or "neutral"—often a euphemism for "sell," which has but vanished from the analysts' vocabulary. Even Andrew Shore, an analyst at PaineWebber Inc. who was early to spot inventory problems at Sunbeam Corp., downgraded the stock to only a neutral rating on Apr. 3, and the stock fell 25%, 34. "I saw that neutral as a sell," says Shore. "No need to yell 'Fire' in a crowded theater. I was just trying to be diplomatic." Sunbeam is now at 7.

OPTIMISTS ABOUND. Today, a mere 14% of all analyst recommendations on some 6,000 companies are sell vs. 67.5% buys and 31.1% holds, according to Zacks Investment Research. It hasn't always been this way (chart, page 154). In mid-1980 for instance, 24.5% of the recom-

mendations were buys, 26.8% sell. But by the end of the '80s, buys outnumbered sells for to one, and by the early 1990s, eight to one. One explanation for the lopsided number of buys is the bull market. Still, the number of buy recommendations has continued to climb over the past 12 months while the average U.S. stock was losing 10% of its value.

OUTCASTS

Analysts are expected to support their firms' investment-banking deals—or else

Investors are bombarded with bullish sound bites and "strong buy" and "outperform" tips in print and on the air. Analyst recommendations are finding their way online as well. DLJ Direct and Morgan Stanley Dean Witter's Discover Brokerage Direct offer their reports to clients, and so does Charles Schwab & Co.'s Web site will feature research from First Boston and Hambrecht & Quist. Investors picking up such tips need to be wary about motives. Official research reports must disclose if the firm is or has been involved in an investment-banking relationship with the company. But new reports of recommendations may not carry such disclaimers.

GREENER PASTURES. The war between investment research and investment banking began in the 1980s, but it has heated up in the deal-crazed '90s. The reason is simple: money. Most Wall Street research is pitched to institutional investors who pay the firm about a nickel a share in commissions. But if an analyst spends his time trying to land an initial public offering, the firm can earn 15 to 30 times that amount per share. Merger advisory fees can be sweet as well. And directly or indirectly, some investment-banking fees will find their way back to the analyst's pocket. Wall Street execs admit analysts walk a fine line when they work in both research and investment

Cover Story

WHO CAN YOU TRUST?

high regard for a select few. "Maybe 20% are intellectually honest," says Richard Strong, chairman of Strong Funds, with \$32 billion in assets. "And you assemble a trapline from them and try to replace those as they leave or retire."

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Analysts routinely play up good news and sugarcoat the bad. Positive corporate news—an unexpectedly strong earnings re-



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banking. "We warn them that if they lose credibility with investors, they're of no use to investment banking either," says Mayree Clark, global research director at Morgan Stanley Dean Witter.

But what happens when there's a conflict between objective analyses and the demands of investment bankers? "Conflict?" asks Brown, the former DLJ analyst. "There's no conflict. That's been settled. The investment bankers won." It's not far from the truth. "Of all the jobs on Wall Street, the company analyst's role has changed the most in the last five years," says Alan Johnson of Johnson Associates, a Wall Street compensation consultant. "The analyst today is an investment banker in sheep's clothing."

Equity analysts are a staple of the financial media, *BUSINESS WEEK* included, and the media doesn't always indicate when an analyst is speaking objectively. On June 8, for instance, Robert B. Albertson, banking analyst for Goldman, Sachs & Co., appeared on both CNBC and on the *Nightly Business Report* extolling the virtues of the just-announced merger of Wells Fargo & Co. and Norwest Corp. Both shows identified Albertson as a Goldman analyst, but neither said the firm was the investment bank on the deal. Goldman stands to collect about \$40 million in fees when the deal closes.

But even more questionable is that Albertson appeared on the shows at all. It's common practice on Wall Street to bar analysts from even talking about a company if the firm has an active investment-banking relationship with it. Albertson says his remarks were appropriate and "not over the line. My customer is the investor, and if I see something I like, I should be able to say that." Albertson says he wasn't part of the investment-banking effort on the merger at Goldman.

Should analysts ever wear the hat of the investment banker? Brown says no. For instance, as an analyst, he helped DLJ investment bankers market two secondary offerings for subprime lender Olympic Financial Ltd., now known as Arcadia Financial Ltd. Brown was a bull on the stock anyway but concedes the fact that the equity offerings paid an additional six-figure sum might have affected his judgment. In contrast, there's no direct compensation for a buy recommendation, but analysts are rated by the firm's traders for how much business they generate. "The difference is, in an underwriting, the analyst has a big incentive to like the company a whole lot more," says Brown.

These days, Wall Street firms recruit analysts who can land investment-banking clients. "I got a phone call from a headhunter who was looking for a semiconductor analyst for Prudential Securities," says Eliot Glazer of DuPasquier & Co., an independent researcher for institutional clients. "The first priority was investment banking; the second, investment

PAYBACK

Companies have an easy way to deal with harsh analysts: Cut off their access



TOO BEARISH: Analyst Lipton irked Boston Chicken

research." A Prudential spokeswoman says "it doesn't sound right that a headhunter would say that." She says the firm believes research and investment banking are complementary businesses.

There's no question that an analyst can be a rainmaker. "Having a top analyst has been essential in bringing in IPOs," says Joan Zimmerman, a headhunter at G.Z. Stephens Inc. Indeed, in most "bake-offs," competitions in which investment banks pitch their services to a potential client, the analyst is a star of the show. That's because a rousing endorsement from a highly ranked analyst is thought to be able to send a fledgling stock into orbit. And the firms play that to the hilt. *BUSINESS WEEK* has viewed an internal document prepared by a major Wall Street firm to a company planning an IPO. The "pitch" stated that the firm's analyst would serve as an "advocate" for the company.

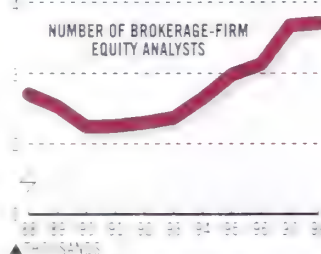
And it's not only IPOs. A sharp analyst can draw other dealmaking as well. "If I like a company, we [the firm] try to become its investment banker," says technology analyst Michael K. Kwatinetz, who with his 17 analysts and over 120 investment-banking colleagues recently moved to First Boston from Deutsche Securities Inc.

"If you think a company should do something, it's nice when you have an arm of the firm that can try to make that happen," he says.

Kwatinetz' investment-banking cohorts have arranged acquisitions for Gateway and Hewlett-Packard, an equity offering and divestiture for

The Bull Market In Analysts

NUMBER OF BROKERAGE-FIRM EQUITY ANALYSTS



Cover Story

WHO CAN YOU TRUST?

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Micron Technology, and two hedging programs for Dell Computer. Now, six of the eight companies he covers are also investment-banking clients. Only one, Wind River Systems Inc., was a client at the time he started covering it.

Not surprisingly, some analysts make more than the dealmakers. And Zimmerman estimates that total cost for equity research has quadrupled in the 1990s—though with Wall Street's slump, 1998 pay levels will likely fall below 1997's.

Even if that happens, the dollars are still huge. At the major investment banks,

Cover Story

WHO CAN YOU TRUST?

salary, bonus, stock, and options for an *Institutional Investor* first-team analyst can easily run from \$2 million to \$5 million, especially in industries like telecom, technology, media, and health care. Even the next tier runs in the \$750,000 to \$1 million range. Junior analysts still learning the trade can earn \$500,000 to \$750,000, and for grunts whose work backs up the senior analysts, \$250,000 to \$400,000 is not unknown. Veteran telecom analyst Jack Grubman recently became the first of his kind to achieve NBA-star-like status: Salomon Smith Barney reportedly agreed to a \$25 million one-year package to keep the analyst (page 156).

Not only are the analysts taking home a bigger piece of Wall Street's pie, but there are more of them. After the 1987 stock market crash, the number of full-time analysts dropped until 1992, when it bottomed at 2,313, according to Nelson Information. But spurred by a bull market and deal mania, the ranks have since swelled to 3,724. And that doesn't include the legions of support staff who now do much of the number crunching, freeing the top analyst to visit companies and clients to push stocks and investment-banking deals.

HEATED EXCHANGE. The great fear of the analyst when he or she goes calling on a company is to find the door shut. Roger Lipton of Lipton Financial Services Inc., an independent research boutique, was refused attendance at a 1995 Boston Chicken Inc. investor conference. He had been an early critic and a bear on Boston Chicken, the once-sizzling chain whose stock has since turned to toast. Brown was barred from First Union Corp.'s Charlotte (N.C.) headquarters. He repeatedly clashed with Edward E. Crutchfield, the chairman and CEO. At a First Union analysts' meeting in New York last November, Crutchfield, from the podium, and Brown, from the audience, exchanged heated words.

These aren't isolated incidents—and they will continue to happen. Consider a recent survey of Wall Street research, sales, and trading practices conducted by the Tempest Consultants Inc. and sponsored by Reuters Holdings PLC. The survey asked 272 large U.S. companies what their reaction would be to an analyst's sell recommendation. One-third said they would exclude the analyst's firm from investment-banking business, and nearly as many said they would "reduce communications and reduce access." A study



EUPHEMISMS

These days, bad news gets a "hold" or "neutral" recommendation

of small to midsize companies turned up similar results.

It's not just companies that analysts fear to offend. Lipton recalled an analyst who had expressed bearishness about Boston Chicken to him but kept recommending it to clients. Why? "It turned out that a large mutual-fund company had 5 million shares of the stock, and he feared if he lowered his rating, that fund company would 'come crashing down on him,'" says Lipton. Another analyst, who asked not to be identified, said he also

gered a major mutual fund company when he put out a sell on a holding of theirs. "When you say sell, it's supposed to be a service to a client,"

GUTS: Conder didn't mince words about Callaway

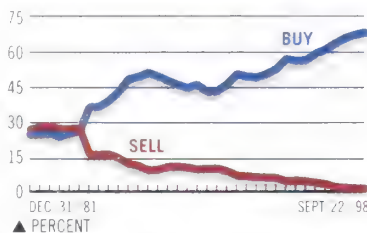
says the analyst. "But it was taken as a slap in the face, a challenge to their judgment. They didn't want to hear it."

Bad news gets blocked by other agendas. Brown was involved in a 1996 effort to find a buyer for Olympic and so was barred from commenting on the stock. Several buyers came to look at the books—and backed out. Word leaked out that the deal was in trouble, and the stock started to fall from the mid-20s. Brown says he knew many of his clients were losing money—and couldn't say anything. The company, now Arcadia, was never sold, and trades at around 5 a share.

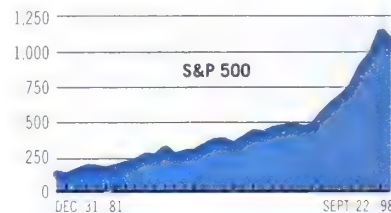
The situation was similar for Josephine Esquivel, the apparel analyst at Morgan Stanley Dean Witter who covered fashion house Donna Karan International. Morgan had been the lead underwriter for Karan's \$24-a-share IPO, and Esquivel issued the obligatory "strong buy" recommendation a month

Sell? Who Said Sell?

During the long bull market, Wall Street analysts have pumped up the buy recommendations and forgotten how to say sell. Part of this comes from the improvement in the environment for equity investing. But now only 1.4% of all recommendations are negative. Have things gotten that good?



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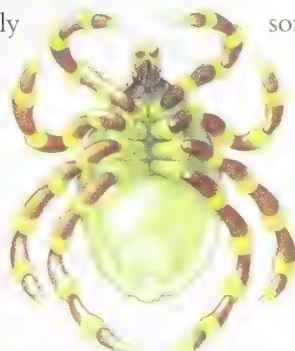
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later and reiterated it several more times. But Karan's stock started to slide within weeks of the IPO—an embarrassment for the underwriters—as the company ran up huge expenses and large losses. In March, 1997, Karan hired Morgan Stanley to unload its beauty-products business. That was tantamount to a gag order, says the analyst. “I couldn’t even change my rating or even an earnings estimate,” she says. Esquivel

was prohibited from commenting on Donna Karan for 15 months.

For unbiased

evaluations, institutional investors look beyond the major Wall Street firms. Big investors often give high marks to the research efforts of Sanford C. Bernstein & Co., which does no investment banking. They also turn to research boutiques like Lipton’s or DuPasquier, the firm with which Glazer is affiliated. “I’m a dinosaur,” says Glazer, who, with 30 years of Wall Street experience, remembers the days

when equity analysis and investment banking were distinctly different functions.

St. Louis-based A.G. Edwards & Sons get high marks for solid research, in part because it’s not a major investment bank. “Putting a sell on a stock is not pretty for me or for the company,” says Edwards’ recreation-industry analyst Timothy Conder, who in mid-July issued an unambiguous sell on Callaway Golf Co. “But I’ll do it if it’s right for my client.” Conder had lowered the rating to “reduce” in early March, arguing that bad weather and the deteriorating economies of Asia would crimp profits. The stock was then at 32. Conder reiterated the rating several times before dropping to a sell in 19. It was a great call: The stock trades around 10.

For sure, brokerage firms are not about to break up the money machine that pairs analysts with dealmakers. All analysts are not about to risk offending the companies they cover. Woe to the investor who doesn’t keep these two ideas in mind before investing on a stock recommendation.

By Jeffrey M. Laderman in New York, with bureau reports

Cover Story

WHO CAN YOU TRUST?

THE SUPERSTAR WHO WEARS TWO HATS

What makes Jack Grubman the Michael Jordan of analysts? As lead telecom analyst for Salomon Smith Barney, he does what any analyst does: He issues recommendations on stocks. But his paycheck this year is a five-year package of cash and stock that was worth \$25 million before the stock of Travelers Group Inc., Solly’s parent, dropped by 47%. Even now, it’s probably worth more than \$10 million.

Grubman gets the big bucks because he’s among Wall Street’s hottest “superanalysts,” high-ranked analysts who also bring in lots of investment-banking business. In the past two years, he has helped orchestrate some of telecom’s biggest deals. His friendship with Worldcom Chairman Bernard C. Ebbers helped land Solly the role of lead investment banker in the \$35 billion WorldCom-MCI merger. Competitors also say Grubman was a key figure in Solly’s winning the advisory business in SBC Communications’ \$62 billion planned merger with Ameritech and Bell Atlantic’s \$53 billion deal for GTE Corp. **AWKWARD POSITION.** These and other deals account for a tidy sum—some \$200 million in fees and related investment-banking income since the beginning of 1997, according to Securities Data Corp. While Grubman didn’t bring in all that business, industry sources say he brought in more than half. Grubman declined to comment. A Salomon spokeswoman declines to comment on Grubman’s production of telecom deals but says the firm had been strong in the field even before he arrived in 1994.



playing with the devil,” says one competitor. The Solly spokeswoman says “the firm maintains strict ethical wall procedures to insulate research from confidential information related to the firm’s banking clients.”

Despite his investment-banking activities, investors who follow Grubman’s analytical work don’t seem to have any complaints. In fact, he was the top “wireline services” analyst in *Institutional Investor*’s most recent survey. “He’s accessible, knowledgeable, and I don’t think he is unduly influenced by investment banking,” says

RAINMAKER

Serving the role of both analyst and banker, Grubman is “playing with the devil,” says a competitor

Grubman’s dual role as analyst and banker can put him in an awkward position. As an investment banker, Grubman may become privy to inside information that he could be barred from sharing with investors and clients, even if it altered his investment opinion on the company. Sources close to the WorldCom-MCI deal say Grubman sat in on closed-door meetings weeks before the merger was announced that are normally off limits to analysts. “He’s

Brian B. Hayward, manager of the Invesco Worldwide Communications Fund. “All the big-name analysts have investment-banking ties, and those of us on the other side have to keep that in the back of our minds.”

Grubman may be top gun in telecom now. But if one of the deals he orchestrates—and backs up with a “buy” recommendation—turns sour, his NBA-size pay package might be susceptible to serious downsizing.

By Geoffrey Smith in Boston

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HELP FOR INVESTORS

How to spot trouble

Scott W. Schoelzel is a very successful investor. As manager of the Janus Twenty Fund, he boasts a three-year average annual return of 28%. Even with this year's rocky market, he has managed to post an impressive 21% gain through August. One reason for his success: The \$9.3 billion fund is limited to holding about 30 stocks, so he has time to carefully monitor each one. As a result, he managed to dodge such bullets as Sunbeam Corp., selling his shares long before

earnings growth. If that something proves to be accounting gimmickry, trouble may not be far off.

COMPARE REVENUES AND RECEIVABLES

Annual reports list sales for the last three years on the consolidated statement of operations. Two years of "accounts receivable" are found in the consolidated balance sheet. Calculate each rate of growth. If receivables are piling up faster than sales, the company is not getting paid for the revenue

Cover Story

WHO CAN YOU TRUST?

the collapse that lopped off 86% of its value.

So what are the tricks of the trade? While no one—even a savvy investor such as Schoelzel—can spot the sort of accounting fraud that led to the collapse of Cendant Corp.'s stock, there are plenty of places investors can check to test how healthy a company really is. If you know where to look in the financial statements, it's not that hard to spot the kind of aggressive accounting that can lead to a financial meltdown. And if you know how to carefully read analysts' reports, they too can be packed with useful information. Here's a short guide on how to look for those elusive clues to a company's changing fortunes.

WATCH THE CASH FLOW

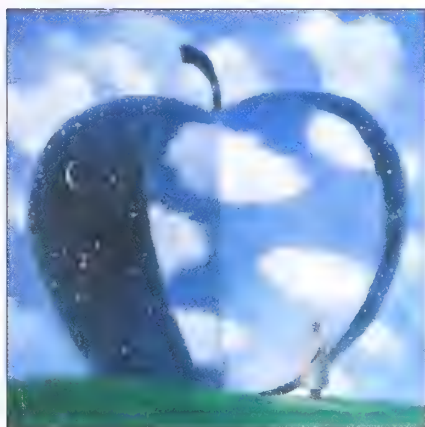
A company posting strong net income growth but negative cash flow could be in trouble. You'll want to look at cash flow from operations, a breakout of which appears in company quarterly and annual filings. Since this cash flow represents the revenue a company is getting from customers minus its out-of-pocket costs, it's the purest measure of how strong core operations are. If cash flow from operations is growing more slowly than net income, or not at all, management is relying on something else for

BIG PICTURE Don't look at any one number. It's the ensemble that counts



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Hopkins to create IntelliHealth, the most comprehensive online consumer health information network. Another investment yielded the Academic Medicine and Managed Care Forum. Through it we've funded research to improve access to care. ■ And we've joined with the American Heart Association in warning women about the number one threat to their health—heart disease. Simply said, we're putting our money firmly where our mission is. That's the price of entry for having one to begin with. ■ For our brochure on how we are raising the quality of health care, contact us at 1-800-AETNA-42 or our Quality Center at www.aetnaushe.com.



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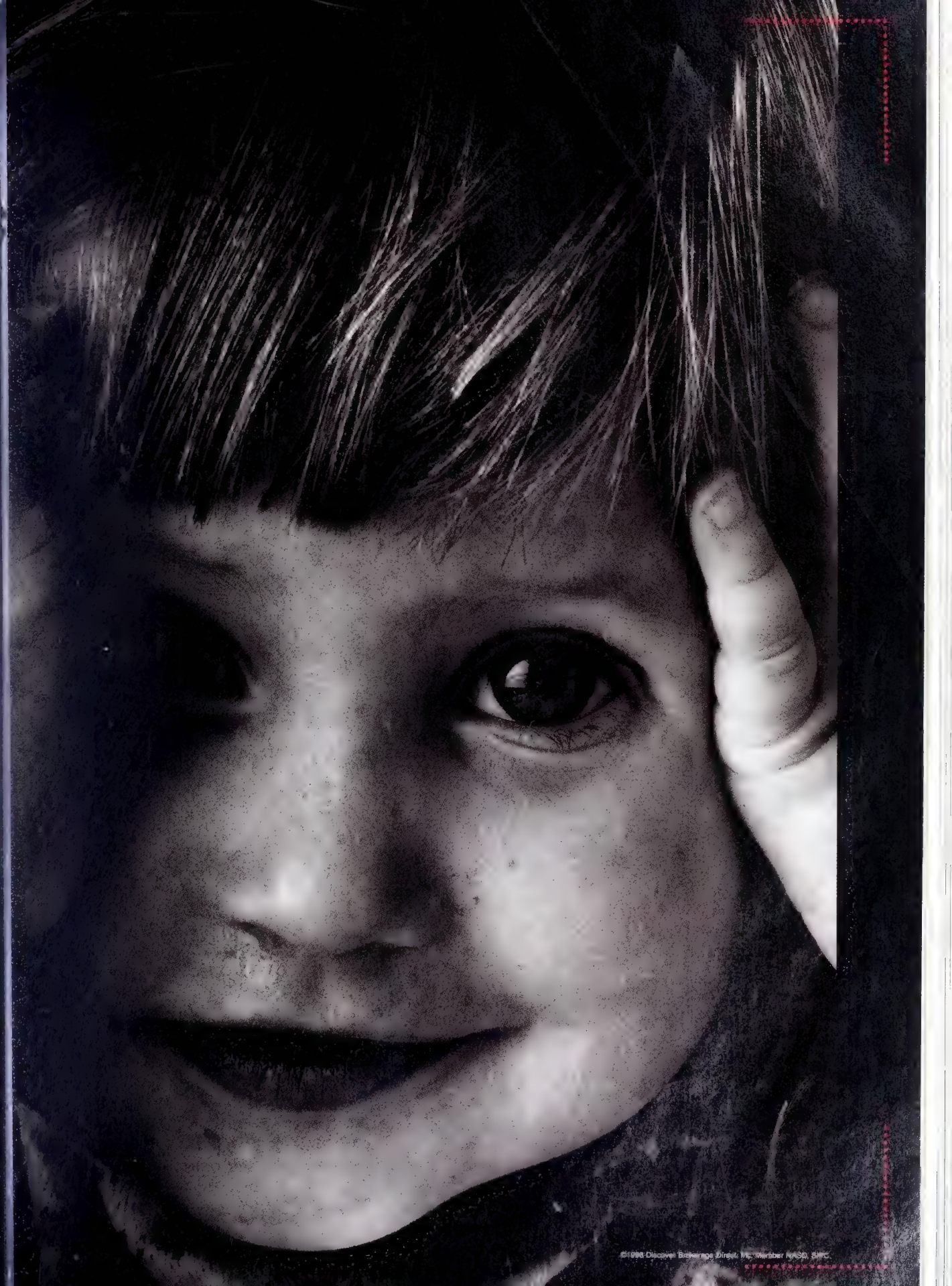
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is booking. Any unusual spikes in receivables, up or down, can indicate some kind of revenue manipulation—and that may lead to future earnings problems.

GET OUT THE MAGNIFYING GLASS

The fine-print footnotes to financial statements can be dry reading. But forge ahead, since they contain important information. The size of a restructuring reserve, along with the details of how much has been spent so far and on what, are broken out in a footnote. This is the place to check if money is being fed back, through the reversal of the charges, to pad income. If so, when the reserves run out, earnings may weaken.

Companies total their in-process R&D write-offs under "operating costs and expenses" on the consolidated statements of income. But there should be a detailed footnote, too. The details are often minimal, though that can change when regulators are watching. After the Securities & Exchange Commission started asking questions about such charges at Envoy Corp., management penned five pages of explanation about three deals, points out Pat McConnell of Bear, Stearns & Co. That kind of information can help you assess whether management has made a smart move or just blown a lot of cash.

CHECK BEYOND EARNINGS

Looking at a multiple of measures to size up a company will minimize the risks of making an investment based on earnings numbers that have been manipulated. In a slowing economy, professional investors suggest focusing on debt levels (they shouldn't be climbing too quickly), gross margins (if they're falling, a company may be selling goods at fire-sale rates to maintain market share), and inventory levels (growth here could signal a dearth of sales). "No one thing tells you the entire story, but taken together it gives you a good picture," says Schoelzel. Even if you're loath to search through

a company's financials yourself—or just love to pore over research reports from your

broker—you shouldn't take Wall Street's advice without a very large grain of salt. In going through the analysts' reports, there are a number of things to watch out for as well.

BEWARE INVESTMENT-BANKING LINKS

The first question to ask about any recommendation is if the analyst's firm is also the investment banker for the company. If so, that will appear in the fine print on a brokerage firm's report. If you hear about the recommendation by word of mouth or the media, dig deeper by calling the analyst's firm or the company's investor-relations department.

Be especially wary of early recommendations in the case of initial public offerings. The first recommendations usually come from the firm or firms that lead the underwriting. Kent L. Womack, a finance professor at Dartmouth College, says

Net Assets

Here are a few Web sites that can help you figure out what's behind corporate financial statements and Wall Street reports:

securities.stanford.edu Look for lawsuits against a company on the Securities Class Action Clearinghouse site. Some 59% of the cases detail accusations of improper accounting.

www.aapub.com Check out the Briefs & Letters section for short articles on current accounting-related issues excerpted from the *Analyst's Accounting Observer*, a newsletter written for professional investors. And don't miss the "National Charge Clock," an up-to-date tally of corporate write-offs.

www.briefing.com Use the free Story Stocks section to search for news that might be moving a stock. Daily updates signal when analysts upgrade or downgrade a stock and when brokerage firms initiate coverage.

www1.zacks.com Analyst Watch service includes daily E-mail alerts on analyst changes affecting stocks and abstracts of broker recommendations.

these bullish reports from the investment banker's analyst are usually issued when the stock is below the offering price. "That's why we call them booster shots," says Womack.

If an IPO starts to look like a winner, other analysts will start coverage. Womack studied stock price behavior on the day buy recommendations were issued. But from analysts uninvolved in the underwriting resulted in a 3.5% price gain vs. a 1.5% gain for those from the underwriter's analyst.

DECIPHER THE RATINGS

Some firms use a simple three-part rating system—buy, hold, and sell—but most embellish it. Robert S. Harris, a business professor at the University of Virginia, says adding gradations gives analysts "wiggle room" to avoid negative recommendations.

Some, like A.G. Edwards, Sons and Merrill Lynch & Co., use a five-rung ratings system: two levels of buy, a neutral, and two levels of sell. Many more stocks earn top grades than the bottom. Right now, 543 of 3,825 Merrill Lynch analyst recommendations

are in the top rating. Only eight have an outright sell.

Some firms, like Morgan Stanley Dean Witter, use a four-part system: strong buy, outperform, neutral, and underperform. Notice that the system gives more prominence to telling investors to buy than to sell, which is couched in "underperform." It means the same thing. Who wants to hold a stock that's expected to be an underachiever?

At first blush, a hold, or "neutral" or "market performer" doesn't sound so bad. What's the harm in holding it, especially if the company is still sound? Maybe no harm if you're a long-term investor. But in the short run, the stock may get cluttered. Institutional investors may dump the stock. The goal is to beat the market, so they can't afford to hold on to a stock that's only expected to match it. That's why many pros consider a hold to be a sell.

WATCH FOR DOWNGRADES

With Wall Street's bullish bias, any downgrading is big news. Harris says downgrades have a far greater negative impact on stocks than upgrades have positive. Even moving from the highest to next-highest rating can trash a stock.

Big institutional investors know the analysts' pronouncements are not always what they seem. But unlike individual investors, they often meet and talk with analysts. "A wink, a nod, or some other body language tells more than the report," says Kevin Landis, portfolio manager of the Firsthand Technology Value Fund. "It's the individual investors who are most susceptible to misreading the ratings," says Bill Gurley, an ex-technology analyst, now a partner at Hummer Winblad Venture Partners. But if the individual knows how to look under the company's financial hood directly, chances are he or she will come a lot closer to getting the professionals' edge.

By Nanette Byrnes and Jeffrey M. Laderman in New York

Cover Story

WHO CAN YOU TRUST?

broker—you shouldn't take Wall Street's advice without a very large grain of salt. In going through the analysts' reports, there are a number of things to watch out for as well.

BEWARE INVESTMENT-BANKING LINKS

The first question to ask about any recommendation is if the analyst's firm is also the investment banker for the company. If so, that will appear in the fine print on a brokerage firm's report. If you hear about the recommendation by word of mouth or the media, dig deeper by calling the analyst's firm or the company's investor-relations department.

Be especially wary of early recommendations in the case of initial public offerings. The first recommendations usually come from the firm or firms that lead the underwriting. Kent L. Womack, a finance professor at Dartmouth College, says

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NETSCAPE

Special Report

The Net is moving toward one-to-one marketing—and that will change how all companies do business

Now it's YOUR WEB

Soon after Jeri Capozzi logged onto the online nursery Garden Escape Inc. last winter, she was hooked. And it wasn't just because the World Wide Web site offered unusual plants, such as hyacinth beans, firecracker, and dog's tooth violet. It's because Garden Escape created a personal store just for her. Greeted by name on her personal page when she visits, Capozzi can take notes on a private online notepad, tinker with garden plans using the site's interactive design program, and get answers from the Garden Doctor. So far, the 41-year-old insurance caseworker from Litchfield, Conn., has spent \$600 at Garden Escape and has no plans to shop at any other nursery. With service that personal, she says, "I probably will never leave it."

Personal service on the Internet? Isn't that an oxymoron? For most Web surfers, the Net has been just another aloof mass medium like television, radio, and newspapers, dishing up a morass of information that you then have to sift through. But as consumers such as Capozzi are discovering, the Net is finally beginning to cast off the mistaken identity of its youth and deliver on its original promise—the ability to tailor itself to every one of its 100 million users.

Don't think "mass." Think "me." Like no other mass medium or marketplace, the Net offers merchants the ability to communicate instantly with each one of their customers. The Net also lets those customers talk back, so that they can demand unique products and customized services. Until now, few Web-site operators have taken full advantage of this inti-

mate link, but that's changing. According to a survey of 50 top online merchants by New York market researcher Jupiter Communications, 40% say they have begun to offer personalized features, with 93% saying they will within a year.

If personalization pops up all over the Net, it could usher in a new era in electronic commerce—one that threatens to shake the foundations of conventional mass marketing and mass production. Indeed, the real kick from the Net's personal touch will go far beyond marketing and sales. Ultimately, it could transform not just merchants' contact with customers but all their operations, from how they research and design products to how they're manufactured.

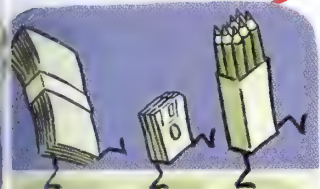
CHANGING FOCUS. For most of this century, mass marketing and production have held sway, thanks to both the exploding population and the incredible production efficiencies of the Industrial Age. It just didn't make economic sense to provide products and services customized to each buyer. And without a cost-effective way to track the purchases and preferences of individuals, marketers had to resort to inexact measures, such as demographics, to sell their wares.

Now, the Net—and its ability to reach the masses individually yet economically—may mark a historic swing back to one-to-one marketing. That could change merchants' focus from gathering a mass of customers for their products to getting products that fit individual customer demands. "The technology has caught up to the number of people in the world, and we've come full-circle," says Steve Kanzler, chief executive of LikeMinds Inc., a personalization technology company with



7 A.M. Stumble out of bed and log onto MyExcite (www.excite.com), which greets you with a cheery "Welcome Harry," for your local weather and info on your personal stock portfolio.

9 A.M. In the office, you're running on floppy disks and printer paper. Log into your personal count on the company intranet with Office Depot (www.officedepot.com), click on new boxes, and the stuff's on way.



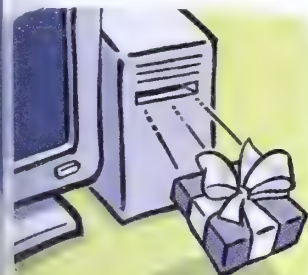
10 A.M.

Calling up your department's intranet page, you print out market research reports on rivals you had asked a software "agent" to search for.

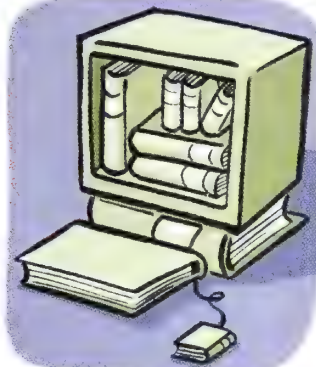
11 A.M. American Airlines (www.aa.com) just sent an E-mail with a special fare on your usual business route next week.



2 P.M. An E-mail from Amazon.com (www.amazon.com) tells you the John Grisham book you asked to be alerted about is out. You hit the hyperlink, land at Amazon.com, and with one more click, the book is on its way to you.



12 P.M. While you're at the deli, your cell phone beeps. The digital readout says some stocks you own hit predetermined sell prices. Tap in your sell orders, and they go out instantly over the Net to your broker.



3:30 P.M. An alert on your customized contact service at PlanetAll (www.planetall.com) says your dad's birthday is next week. Log onto the comparison shopping service MySimon (www.mysimon.com), which sends out a personal "bot" to scour the Net for the lowest price on the Sinatra boxed set.



7:30 P.M. The kids want a dog. Surf over Ralston-Purina's breed finder (www.purina.com), fill out the questionnaire on your lifestyle and the kinds of dogs you like, and the site provides a ranked list. Yikes—a St. Bernard's at the top.



9 P.M. You'll need a bigger house to fit that St. Bernard. Log onto Coldwell Banker's Personal Retriever homebuying site and peruse your personal portfolio of homes that meet your criteria.

10:30 P.M. While listening to a popper drone on about wilds, you surf Garden Escape (www.garden.com), check out dscaping plans you did line for your garden, click on Plant Finder for what will w in that sunny border, and er the suggested rigolds.



10 P.M. Time to relax. At Imagine Radio (www.imagine-radio.com), click on "Harry's Jazz Station," a Web audio feed programmed with your favorite artists, and let Miles Davis blow your tensions away.



the slogan: "Every individual is a market."

Early signs show personalization has a huge payoff. Jupiter reports that customization at 25 consumer E-commerce sites boosted new customers by 47% in the first year—and revenues by 52%. Even at a cost of \$50,000 to \$3 million for the personalization software, along with computers to store the customer profiles, personalization generally pays for itself within a year.

Music retailer CDnow Inc. already is singing its virtues. On Sept. 16, it launched My CDnow, which lets customers get a page designed just for them with music suggestions based on their stated preferences, past purchases, and ratings on artists and CDs. CDnow has seen an immediate benefit in consumer interest: The number of pages viewed on one of its features, called "Wish List"—which appears on the customized pages and lets shoppers name CDs they may buy later—jumped 200% almost immediately. "It really is a music store for each of our 600,000-plus customers," says Jason Olim, CDnow's CEO. "At the end of the day, it will mean more revenues."

Only if cybernauts are of the same mind as merchants, who think the upside of personalization outweighs the downside. So far, the answer to that is decidedly mixed. Because customizing requires people to cough up personal information and fill out sometimes lengthy forms, only a small fraction of Netizens have done so.

Worse, there are rising concerns about privacy, which could prove the Achilles' heel for personalization. Too often, sites step over the fine line between being personal and being nosy. And many Web surfers chafe at the very underpinnings of personalization: To build customer profiles, Web



LOYAL CUSTOMER: Jeri Capozzi is hooked on Garden Escape's site

merchants often monitor an electronic trail that reveals all sorts of things about users—say, that you're a 28-year-old male Los Angeles office worker who likes vegetarian food, Jackie Chan movies, and mystery novels. "Personalization to many Web sites means, 'How can I sell you out to an advertiser so I can charge more for ads?'" says Steve Tolin, CEO of PersonaLogic Inc. of San Diego, which makes personalization software.

Alarmed, government officials are threatening federal regulation that could severely limit the use of personal data by merchants so badly need to offer tailored products. One encouraging sign: Most E-merchants seem increasingly aware that they have to be upfront with customers

and they're devising ways for cybernauts to surf incognito (page 174).

SNEAKY PEEPERS. Even if fears of sneaky peepers are assuaged, personalization faces yet another hurdle. For all its promise, it still is crude and cumbersome. Personal-recommendation technology, which uses complex mathematical formulas to match people's likely interests, has a long way to go before it lives up to your most trusted critic's suggestion. Buy a gift for someone whose tastes you abhor, for instance, and your future customized recommendations may never recover. And separate databases on your habits aren't always matched up: Amazon.com, for instance, sometimes suggests books you have already bought there (page 176).

Still, those who have taken the plunge seem pleased. Porn site Excite Inc. says people who use personalization come back five times as often as others and view double the number of pages. They also tend to stick around when they come. "It has kind of contained my surfing," says Hollywood producer Chris J. Bender, who has his stocks, movie news, and local

Special Report

NET PERSONALIZATION: A PRIMER

WHAT IT IS:

Personalization is what merchants and publishers do to tailor a Web site or E-mail to a consumer based on past behavior, tastes shared with others, age, or location. Surfers either give the data to the site operator, or it can be gleaned by their movements or purchases on the site. Customization involves the active choices that Web site visitors make to specify which news, products, or other features they want to see regularly. The goal for merchants: One-to-one marketing.

HOW YOU USE IT:

Shoppers can use a program called an intelligent agent—also known as a bot—that automatically scours the Net for information, such as prices on products. For customer service, a few Web sites feature a humanlike chatterbot, an intelligent agent that can answer questions in a conversational style. Many retail sites offer customers a recommendation service, which uses complex mathematical formulas to suggest products that match customer preferences.

THE TECHNOLOGY:

Collaborative filtering compares customers' purchase history, stated preferences, or clickstream—where they go on a site—with those of other buyers to determine what they're likely to buy next. Another matching technique is neural networks—sets of programs and data that mimic the human brain to recognize hidden patterns in complex data, such as correlations between buyers of seemingly unrelated products.

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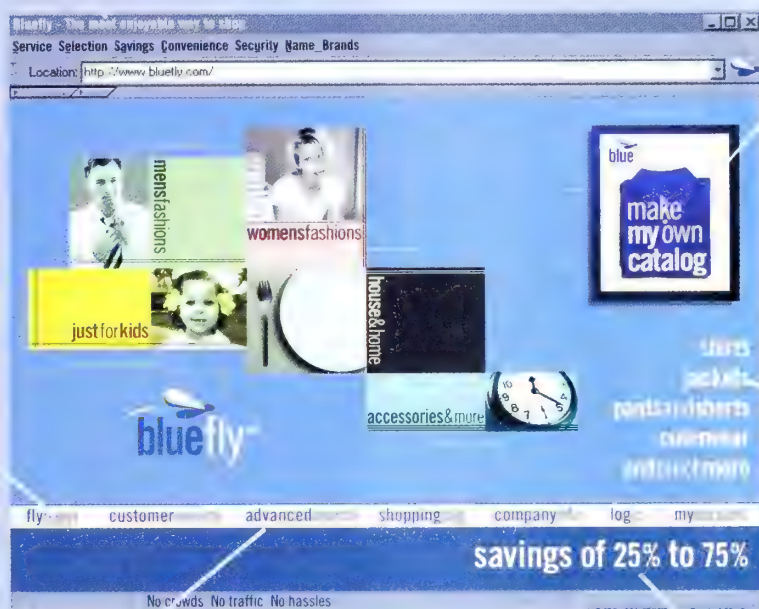
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Or surf over to portals Yahoo! Inc. and Excite. Click on lists of what you want to see and do on the Net, and type in some personal information. Voila! Your MyYahoo! or MyExcite page displays your name and personal E-mail box, news you request, sports stats, the weather, and an alert about your spouse's birthday next week.

It's happening at work, too, where businesses are getting just as up-close with each other online. This month, Office Depot Inc. began offering small-business buyers personalized online catalogs. And new software from Trilogy Development Group Inc. in Austin soon will enable these customers to craft unique Office Depot catalogs for each of their employees—based on their buying authority—and created instantly on demand.

There's a lot more to come. This fall, many of the best-

PACESETTER

Jason Olim

*Founder and
CEO of
CDnow*

CDnow's new personalized site, My CDnow, allows visitors to create a music store that's customized to their individual tastes. "Every single home page will be built on the fly," says Olim. "It really is a music store for each of our 600,000-plus customers."



known consumer sites, such as computer-seller Cyberian Post and N2K Inc.'s Music Boulevard, will launch personalized features to help kick off the holiday selling season. N2K, in a trial run of personalization this year, found that the recommendations prompted people to buy CDs 10% to 30% of the time—a huge leap over the average 2% to 4% rate on the rest of the site.

IN THE RED. Cybermerchants need just that kind of boost. After paying millions of dollars for real estate on portals and other high-traffic sites, few E-merchants are actually making money. Some big ones, such as Amazon.com, are expected to lose money until well after 2000. To earn profits, they have to get customers to buy not just once, but over and over.

For that, a personalized Web experience is critical. To keep coming back—even to hazard an online purchase for the first time—customers need to feel they're getting something no one else in the brick-and-mortar world can offer. That's what Amazon.com is trying to do. By offering personal recommendations, which can change after every purchase and every visit, it hopes to get people to keep coming back. It worked for Christopher Mills, a marketing manager for a Torrance (Calif.) software company. He keeps buying at Amazon because, he says, "it has a real personalized touch." Indeed, repeat buyers accounted for more than 60% of Amazon's \$203 million in sales in the first half of 1998.

Brand-building is just as

Special Report



PACESETTER

David Sze

*Vice-president for
programming,
Excite*

Web portal Excite intends to make personalization easier by letting Web surfers gradually reveal information instead of requiring them to fill out long forms. The result: Visitors stick around. "People who use MyExcite come back five times as often," says Sze.

he has 1200 on her SATs,

letters in three sports,

nd mutual funds from GE.

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important as sales for many merchants. They're finding that personalizing attracts more people and keeps them on their sites longer. Ralston-Purina Co., for instance, has a Breed Selector on its purina.com site that guides people through a series of questions on their lifestyle and what canine qualities they prize. It then spits out a ranked list of dogs that fit their personal preferences. Since the feature was installed in June, the number of visitors has jumped 25%, and they stay twice as long—exposing them to more Purina marketing messages, says Mark S. Whitzling, director of Purina Interactive Group.

Loyal users are just as critical for merchants. They can use the data that members have revealed to help advertisers target the most likely buyers—and charge more for the ads. Right now, an untargeted Web site banner ad averages about \$17 per thousand people reached—less than half the

PACESETTER

John R. Samuel

Managing director of interactive marketing, American Airlines

Using the Internet to quickly target customers, such as parents whose children are on vacation, American Airlines hopes to sell seats that otherwise would have gone unsold. Says Samuel: "We're now able to create a product that couldn't have existed before."



Special Report

rate of consumer magazines. Kent Godfrey, CEO of the San Francisco Web marketing technology firm Andromedia Inc., thinks ad-driven sites need some ads to top \$300 per thousand viewers. "To do that, you have to target on an individual basis," says Godfrey.

It will be an uphill struggle—and not because it can't be done technically. So far, few advertisers target ads online with any more precision than they do in conventional media because segmenting too finely may produce scant customers. "We can show ads to golfers in Kentucky with two kids," says Charles Ardai, president of Juno Online Services, which offers free Net access to people willing to accept ads. "But is it really worth your while doing a lot of work and analysis to target three people?"

Even so, early trials show some promise. Kraft Foods, Bristol-Myers Squibb, Kellogg, and others, for instance, saw an average 27% increase in sales when they ran a targeted banner ad on the grocery-shopping service, Peapod Inc. Even more impressive, San Francisco electronic coupon company planet U found in a trial at Dick's Supermarkets in Wisconsin and Illinois that Web coupons targeted to shoppers' preferences were redeemed 20% of the time—more than 10 times conventional coupons.

For many earthly merchants, the Net's ability to personalize products and services with pinpoint precision adds up to a bowling ball aimed at the very foundations of modern-day commerce. It heralds wrenching change

for how manufacturers, distributors, and retailers will be organized and run. Today, most companies organize themselves by products: Product managers are the basic drivers of marketing. In the future, companies instead will have customer managers, predicts Martha Rogers, co-author of *One to One Future: Building Relationships One Customer at a Time* and a professor at Duke University. Their job: Make each customer as profitable as possible by crafting products and services to individual needs.

HALLOWED GROUND. The upshot is that actual customer demand—not forecasts—will drive production. Dell Computer Corp., for instance, has created some 1,500 customized home pages for its best customers so they get direct access to corporate-specified personal computers, negotiated discounts, and records of orders and payments. This is a big reason Dell's unit sales are growing over 70% a year, light-years ahead of the industry average of 11%.

The Web even allows customers to directly influence the most hallowed province of corporatedom: product research and design. Consider the case of Sapient Health Network. The site offers personalized information for some 115,000 sufferers of 20 different diseases, from breast cancer to hepatitis C. After filling out an extensive questionnaire on their unique conditions, each patient gets a personal "bookshelf" full of symptoms, treatments, and the like, specifically related to their unique ailments.

Originally, Sapient charged subscription fees—but patients balked. So now, Sapient makes money from collecting patient data anonymously, compiling it into population studies, and selling it to drug companies. It also conducts focus groups and recruits willing patients into clinical trials of new treatments.

PERSONALIZATION TAKES OFF...

Merchants using personalization today

40%

Use or will use it within 12 months

93%

New customers after 12 months

UP 47%

Revenue after 12 months

UP 52%

DATA: JUPITER COMMUNICATIONS CO. SURVEY OF 25 COMPANIES

...AND THE PAYOFF CAN BE SWIFT



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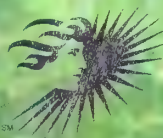
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ments—often with unheard-of targeting, such as people who are incontinent and wet one pad a day. Asks Sapient product marketing director Michael S. Noel: "Where are you going to find these people in the real world?"

Ultimately, these ever-widening electronic links to the customer will lead to the

Special Report

Holy Grail for manufacturers and service providers: mass customization of products. For an early example, look to artuframe.com. The art and framing site based in Lake Forest, Ill., started offering 1 billion possible combinations of posters and frames last May. Using recommendation soft-

ware from Net Perceptions Inc. in Minneapolis, customers narrow down the vast choices—eventually coming up with their unique product. "We're giving total control to the customer," says artuframe.com President William A. Lederer. He expects \$3 million in sales this year.

The Net's ability to reach millions instantly and individually is even creating products that couldn't be sold economically before. American Airlines Inc. recently beefed up its frequent-flyer member site using one-to-one marketing software from BroadVision Inc. Members can streamline the booking process by creating a profile of their home airport, usual routes, seating and meal preferences, and the likes of themselves and their families. With these profiles and a v-

FENDING OFF THOSE PESKY SNOOPS

You're 55 years old, you make \$50,000 a year, and you've been surfing the Web for athletic-shoe supporters. Suddenly, Amazon.com starts urging you to buy safe-sport guides for aging joggers. Even more irksome, CDnow Inc. is recommending you buy '60s oldies by such artists as Iron Butterfly. Jeez. It's bad enough CDnow thinks you're a heavy metal fan. Do you really want these sites to know your salary, your age, and all about your fallen arches?

The trouble is, most of them already do. Consider "cookies," the deceptively sweet name for software that's downloaded into your PC's hard drive, usually without your knowledge. Sent by online merchants, advertisers, and Internet services, they quietly record your Web habits. Each time you visit a site, cookies are uploaded for review by the people who put them there, so they can pitch you products you may find too good to pass up.

Some cookies simply track what you read and buy on a single Web site. But more powerful software, called "tracking cookies," follow you everywhere. These hard-drive supersnoops, often used by advertisers, let marketers combine data from the cookie on your hard drive with the personal information you volunteer when filling out registration forms. Armed with such profiles, cybersalesmen may be able to get at your credit-rating, salary, and lifestyle.

BLOCKERS. What to do? You can block cookies entirely, using the preference settings in the pull-down menus of the two leading browsers, Netscape Navigator and Microsoft Internet Explorer. Or you can curb their snooping. With Netscape Navigator 4.0, you can set preferences so that your browser accepts only cookies that get sent back to the "originating server"—no

more tracking cookies. The result: E-merchants and services are kept from tracing anything you do beyond their site. And there are other ways: Software, such as Kookaburra Software's



TAKE CONTROL

JUST SAY NO Browsers by Netscape and Microsoft let you turn off cookies, data files that track your movements online and are placed on your hard drive when you first visit a site. But much of the Web then is rendered off-limits—and you won't get customized information.

PICK AND CHOOSE COOKIES Trust Labels, a free browser plug-in from Engage Technologies Inc., filters out cookies that might identify who you are or where you live, so you can personalize sites yet remain anonymous. Netscape may put the software in its next browser.

CREATE YOUR OWN PROFILE Software makers are working jointly on a much broader filter called P3P, which would let you tell your browser how much data to divulge.

Cookie Pal (\$15), lets you list sites from which you'll accept cookies. And for \$60 a year, Netizens can subscribe to The Anonymizer, a San Diego-based service that lets you surf the Web and send E-mail anonymously.

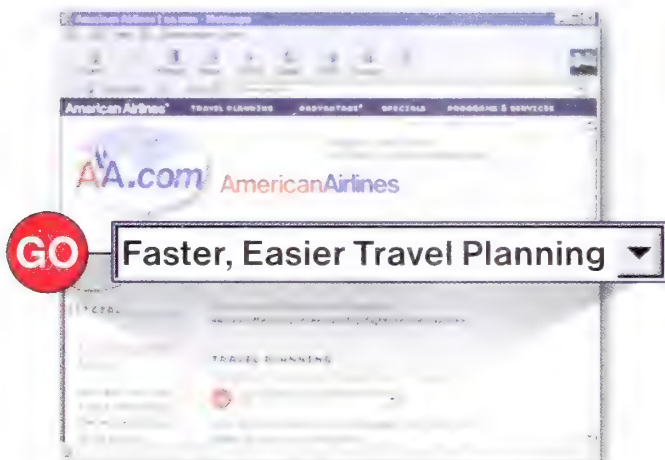
Some Net marketers argue that as long as your real name, address, and phone numbers are protected, it's impossible to overly intrude. "We don't need to know who a person is to customize the experience," says Dan Jaye, chief technology officer of Engage Technologies Inc., which sells anonymous user profiles to online marketers. Over the past five months, Engage has amassed a database of 38 million user profiles, which it sells to advertisers and E-retailers. Jaye says these "can't be used to track you down. If the government subpoenaed our database, we couldn't tell them who you are."

For those still worried, Engage is developing "trust labels," which reject any cookie that marketers or advertisers use to expose a Web surfer's real identity. Engage demonstrated the tool to the Commerce Dept. in June, and Netscape may add it to the next version of its browser, due late this year.

But the most ambitious privacy effort so far is called the Platform for Privacy Preferences (P3P). Software companies are working on a P3P standard that would let cybernauts choose how much personal information to disclose. Under the plan, cybernauts—by setting their browser preferences—may choose to block out everything or agree to disclose only some data, such as their zip code and gender. Progress is slow, however, so consumers may have to wait a while for relief. Until then, the best advice might come from your mom: Don't accept cookies from strangers.

By Paul C. Judge in Boston

What's The ***EAS'TEST*** Way To The Airport?



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to reach members instantly, American can offer, say, parents whose children's school vacations start in a few weeks discounts on flights to Disney World. Says John R. Samuel, managing director of interactive marketing: "We're now able to create a product that couldn't have existed before."

Special Report

As the Net's ability to personalize products and services spreads, terra firma businesses will have to follow suit. How long will Compaq Computer Corp.'s customers, for instance, remain willing to wait longer for shipments and get less-customized PCs than

competitors buying from Dell? "Consumers are going to have the big stick," says Eileen Hicken Gittens, president of Personify Inc., a San Francisco maker of Web customer-analysis software.

Does all this mean the end of mass marketing? Of course not. Many merchants aren't even ready to go online in big way, let alone market one-to-one. But for all the perils of personalization, the real danger is pretending the Net is just another marketing channel. After all, why do you think they call 'em customers?

By Robert D. Hof in San Mateo, with Heather Green in New York and Linda Himmelstein in San Mateo

SOME MATCHES ARE NOT EXACTLY MADE IN HEAVEN

Our reporter finds customizable Web sites are fun, but also a pain in the neck

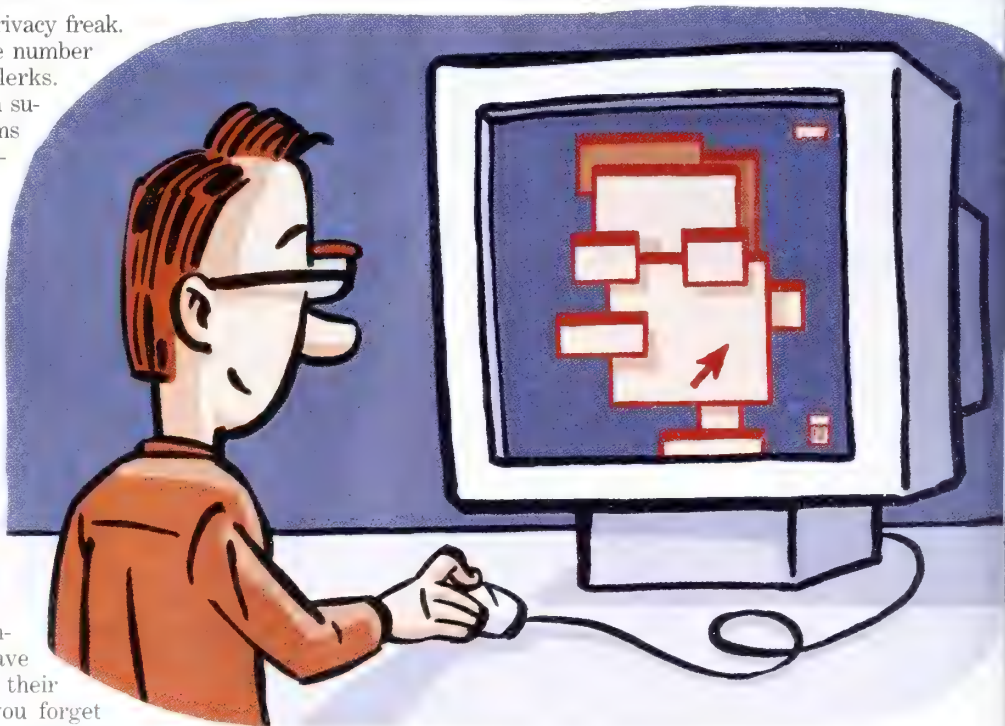
I admit it. I'm a bit of a privacy freak. I memorize a fake phone number for nosy video-rental clerks.

And I don't participate in supermarket rewards programs for fear of revealing my personal data (say, my weakness for Cheez-Its). So even if Web sites promise me personalized news or product recommendations, I often hesitate, or at least fudge data on the registration forms—O.K., so I lie. But to keep our readers informed (and to keep my job), I have sacrificed my privacy to check out customizable sites.

I began my search for My Web where just about everybody else does—at the Internet portals. Since last year, Yahoo!, Excite, Infoseek, Lycos, and others have offered ways to customize their sites in hopes of making you forget they were just supposed to be doorways to everywhere else. I tried MyYahoo first and, to my relief, it didn't ask for much personal info. But I got a cramp from spending a couple of hours scrolling through screen after screen, picking which news, sports scores, stock prices, and other features I want to see on my personal start page.

FIRST-NAME BASIS. An easier way comes from Excite. Instead of forcing you to fill out a form, it asks that you type in your zip code for local weather, your birth date for your horoscope, and so on. Before you know it (that's the idea), you build up a profile that allows Excite to tailor material for you. You still have to make some choices to personalize areas such as news and stocks. But at least MyExcite has manners: It greets me by my name—not "robh56," like MyYahoo.

But I really came here to buy stuff on the company dime.



HURRY UP AND WAIT
Personalized Web sites can test your patience: You'll spend a couple hours clicking and scrolling, for example, with MyYahoo's page setup

Uh, I mean, I want to find out how well the so-called recommendation services work. Merchants like online bookseller Amazon.com use software that logs my interests and purchases and, using complex mathematical formulas to match them to other customers' habits, spits out suggestions for products people with similar tastes have bought. I've ordered only a few books from Amazon, on cooking, the Internet, and Jack Kerouac. So when I ask it for recommendations, I can't blame it for suggesting more books on the N

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and cooking (but nothing, oddly, on Beat Generation writers).

To refine my profile, I dive into Amazon's ratings section and, on countless pages of book lists, click either "I own it" or "Not for me" under each book. There's seemingly no end, so after 20 pages of this, I stop, rub my eyes, and ask for recommendations. In the literature and fiction category, the first six suggestions are by John Steinbeck, many of whose books I told Amazon I own. Not exactly rocket science. The nonfiction category brings up more

Net and cooking fare, plus *Nightwork: Sexuality, Pleasure, and*

Special Report

Corporate Masculinity in a Tokyo Hostess Club. Whoa! Where did that come from? Several intriguing choices do pop up, one of which I buy (*Silicon Snake Oil*, by Clifford Stoll). But I bet the service would be more accurate if I could just type in some favorite books.

Still, Amazon does better than the competition. At barnesandnoble.com, the personal recommendation area is nowhere to be found on the site's first page. No wonder. Once I find it, I work through a dozen screens but find mostly contemporary fiction and only a few books I've read. Sure, make me feel like a philistine. Finally, a blank screen appears. What now? I go back and try the "Get recommendations" button—and it asks me again to rate all those books. Think again.

JOHN DENVER? I hope to have better luck with compact disks. My [cdnow](http://cdnow.com) almost blows it by recommending a John Denver CD immediately after I register my music preferences. I suppose it couldn't know I hate John Denver, but it does know I chose neither country nor folk as a preference. However, after energetically clicking "not for me" on that one and clicking on others I did like—I also could type in my favorite artists and rate records I already own—the suggestions quickly improved. Otis Redding? Bingo.

Emboldened, I move on to movies. Video merchants such as cinemax.com and bigstar.com offer a few good suggestions but also some head-scratchers: C'mon, does anyone actually like the golf farce *Happy Gilmore*? That's why Reel.com Inc. is so refreshing. Instead of hoping that buyers will rate enough movies to build up an adequate database, a staff of 40 real people rates and matches movies before plugging them into a recommendation program. I ask for movies similar to *Pulp Fiction*, and "close" matches spit out *Get Shorty* and *Reservoir Dogs*. Nice. But the "creative" matches were even better: *Fargo*, *Trainspotting*, and *Blue Velvet* (though after watching all those in succession, I might welcome *Happy Gilmore*).

Now, I'm ready for the big kahuna—buying a house. Coldwell Banker's Personal Retriever makes a decent attempt. Clicking through a series of choices on the type of house I want, the price range, the location, and the like, I create my personal portfolio of house listings in the locales I'm interested in. Hmmm—only four in my price range? (How about a raise, boss?) Once I find a listing I like, I click on a calculator to figure what my mortgage would be (ouch!) and get some information on local schools. I can save the listings and get updates via E-mail. It's handy, but limited to Coldwell Banker listings, and it's not all that tailored to my financial situation.

I'll have better luck once I have the house and can get started on a garden. Garden Escape's garden.com offers a raft

of appealing personalized features, starting with a home page tailored to my climate (which it knows from the zip code obtained during a short registration). I also can store orders for plants and tools in a "wheelbarrow" for later purchase, jot notes about plants in an online notebook, and launch a Garden Planner program that lets me plug in plants on a grid representing my garden. A Garden Doctor even answers questions personally.

CHATTERBOTS. For pure fun, though, my favorite customization site is Imagine Radio. It lets me create my own online radio station on the site, which can be heard by anyone through a plug using Real Networks Inc.'s latest player. Clicking away on a long, though limited, list of artists (no classical, for example), I create my own personal station with just the music I like. No Yanni or Michael Bolton for me. Curious? Check out "Radio

Rob": Click on the site's "personal" music button, and it's in the "Carnival" section.

Although these services are supposed to make the Web feel more personal, most none of it feels as if there's someone at the other end of the wire. For that, try a prototype service from Big Science Co.—a so-called chatterbot, or artificial intelligence character. One named Andrette is being tested as a possible concierge at Access Atlanta, a Coldwell Interactive Media city guide. Here's a sample (typed) conversation:

Andrette: "Tell me what you are looking for."

Me: "I'm looking for love."

Andrette: "Say that again, please?"

Me: "What are the best bars in town?"

Andrette: "To discover some great restaurants, click here."

Me: "O.K., how about music clubs?"

Andrette: "Click here for the Access Atlanta music calendar."

Not bad, I suppose, but a entertainment listings index of might work better.

What I initially feared most from these personalization efforts was a deluge of junk E-mail. So far, that hasn't been a problem. I get more spam from two posts to a single Usenet group a year ago than from all my personalized Web adventures.

On the other hand, the E-mail pitches I have received do seem to make use of the personal information I've divulged. American Airlines Inc., whose frequent-flier program I signed up for online, has sent me several E-mails on last-minute *Norwegian* fares and hotel deals—none targeted to my home airport, let alone routes I specified.

Clearly, Web personalization has a long way to go. Navigating the Web's vast resources still requires a steady mouse hand, a big browser bookmark file, and a lot of patience. Oh, and I almost forgot, a good memory. I've created many sign-on names and passwords for security on various sites that I can't remember them all. So I have to write them down—the worst security breach of all. Even so, my personal Web already is useful. I do get things done faster and sometimes discover things I didn't know I wanted—to the detriment of my credit-card balance. I tend to stick around some sites more consistently and even feel a little warmer and fuzzier toward a few. Your results may vary. But that's the whole idea.

By Robert D. Hof in San Mateo, Cal

Getting Personal

Like any new technology, the software behind personalization of Web sites can have some rough edges when it comes to getting your personal page set up or getting back what you want. Our review surveyed a few sites to see whether the experience was a pleasure, a pain, or just so-so.

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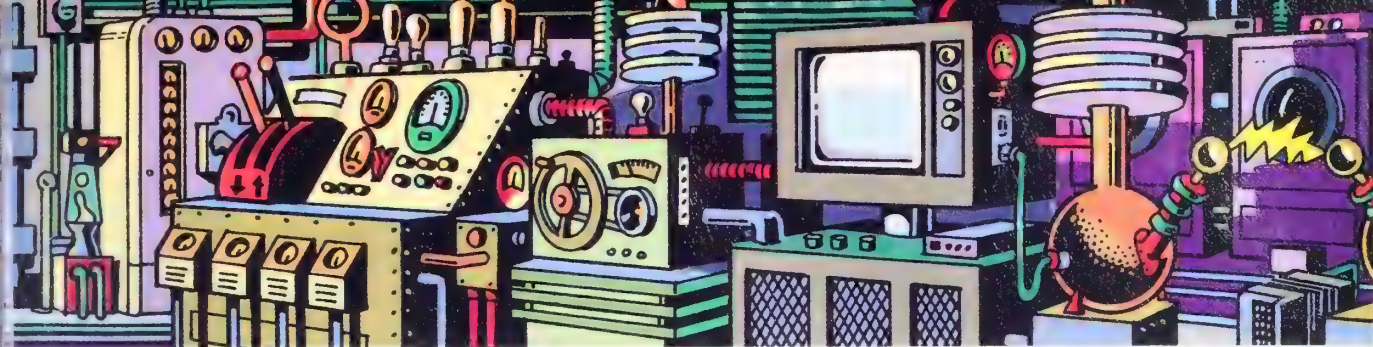
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SOCCER

THE NEW LORDS OF SOCCER

media moguls grab European clubs, the game is changing

A new form of soccer madness has Britain in its grip. This one doesn't feature hooligans beating supporters rival clubs to a pulp. Instead, there is a frenzy of speculation about which media company is going to buy which team for how many hundreds of millions. It started on Sept. 9 with British Sky Broadcasting's \$1 billion takeover bid for Britain's richest and most successful soccer team, Manchester United. The bid was a 51% premium over the club's stock price. The spectacle of Rupert Murdoch's satellite broadcasting juggernaut gobbling up one of the world's most profitable clubs prodded Britain's other media companies. Carlton Communications soon said it was talking to the North London-based Arsenal, winner of last year's FA Premier League championship—Britain's top prize. Other clubs' stock prices are now surging.

CROSS-BORDER BATTLES Behind the big numbers is the realization that soccer is ripe for sweeping changes, not only in Britain but across Europe. Sports programming, which in Europe mainly means soccer, is the lifeblood of the media moguls' fast-growing pay-television empires. So Sky and other broadcasters are eager to make sure they retain the rights to the games. Having a lock on broadcasts of England's Premier League has been crucial to Sky's progress from a struggling upstart in the early 1990s to a money machine that earned \$450 million in the year ended June 30. "There is a natural fit between media and sports organizations," says Mark Booth, Sky's chief executive. Owners of the top clubs want to turn them into a modern, U.S.-style business. It will likely involve much more cross-border competition among elite clubs to maximize television revenues. Under the existing

system of national leagues, the top-tier owners believe, teams waste much of their season playing inferior domestic opponents. They also think the Union of European Football Assns. (UEFA), the sport's governing body, has grossly undermarketed the rights to pan-European competitions.

One change proposed by a Milan-based group called Media Partners would create a new Super League to replace UEFA's Champions League, a tournament among the previous year's top finishers in the major national leagues. The proposal would pit Europe's top 36 teams against one another. Not surprisingly, UEFA strongly opposes the plan and is devising a new tournament of its own, to be unveiled by year-end.

But the top clubs like the idea and have met 11 times with Media Partners to iron out details. The Milanese group is offering a guaranteed total of \$3 billion over three years from the Super League tournament, compared with the \$150 million the clubs received last year from the UEFA-sponsored Champions League. Media Partners has hired J.P. Morgan & Co. to explore ways of ensuring financing, including possibly securitizing expected revenues.

The top clubs also applaud Media Partners' proposal that 18 of the *crème de la crème*, including Manchester United and Italy's Juventus, would be guaranteed spots in the tournament for the first three years. At present, clubs earn their slots with the previous year's performance. Clubs want guaranteed revenues so they can gauge how much to spend signing players. Top players command huge transfer fees and salaries: Internazionale Milan paid \$30 million to



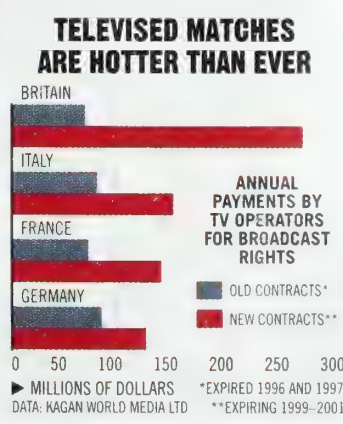
KICKER SHOCK: Salaries are sky-high

Barcelona for the Brazilian superstar Ronaldo in 1997.

No matter which idea wins, the rivalry is likely to alter the structure of the sport. To retain a key role, UEFA will have to improve its performance in marketing TV rights. But that might make existing national leagues, such as England's Premier League, and Italy's Serie A, less important. The widening of an already large gap between the premier leagues and the second-tier leagues might kill off youth soccer programs and squelch grassroots support for the game. And there could be a backlash against plans for a Super League, especially if fans have to pay more for the games.

Still, it seems almost certain that European soccer is headed the way of U.S. professional sports, where lots of franchises are now in the hands of big corporations, many of them in the entertainment business. The fans may not like it, but the game is growing up.

By Stanley Reed in London, with William Echikson in Brussels



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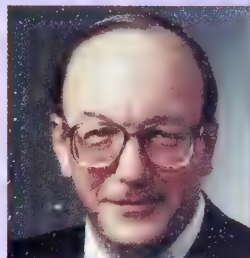
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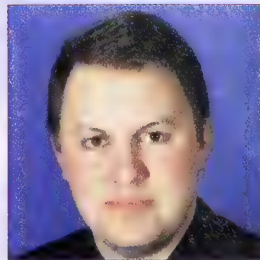
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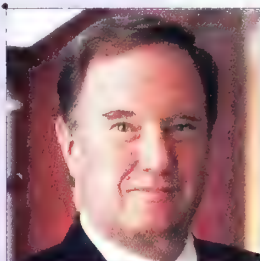
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AN OUTSIDER'S GUIDE TO INSIDE INVESTING

Of all the stocks to crash this summer, perhaps the most horrifying was Ciena, the fast-growing maker of fiber-optic gear. After unveiling plans in June to merge with another hot

INVESTING

telecom outfit, Tellabs, Ciena went from less than 58 before the news to more than 92 on July 20. Then trouble hit, first in the broad market's retreat, next in the defection of a key client, AT&T. By Aug. 21, the day shareholders were to approve the merger, Ciena had nosedived to 26%. Three weeks later, Tellabs scotched the deal, and Ciena plunged to 12%.

Ciena burned arbs and amateur investors alike. Yet one group skirted the damage, cashing in Ciena stock at average prices near 61. Nine insiders, including Ciena's chief financial officer, a director, and five vice-presidents, sold 303,500 shares for more than \$18.5 million during two weeks in June. Had they held on, those shares would now be worth less than \$4 million.

What's remarkable is that the sales, all perfectly legal and reported by July 10 to the Securities & Exchange Commission, did little to interrupt the ascent in Ciena stock. What should have looked like a big red flag to investors went widely ignored. One big reason: The data on corporate insider trading that's gathered and made public by the SEC is a confusing mess.

True, more such information is becoming available on the Internet (table). But conscientious investors like Toronto computer programmer Peter Friedrichsen, who often check insider-trading patterns, still have trouble fathoming which trades are meaningful. "I find it very difficult," Friedrichsen says. "How does the individual really know what an insider trade means?" Nor is it a cinch for the experts. Newsletters such as *The Insiders*, which picks stocks based on insider moves, routinely fail to beat the market after adjusting for risk, confirms

newsletter evaluator Mark Hulbert.

Now, though, help is on the way. A book due out Nov. 1, *Investment Intelligence from Insider Trading* (MIT Press, \$29.95), is the result of 15 years' research by H. Nejat Seyhun, chair of the finance department at the University of Michigan business school. By examining more than 1 million trades insiders made in the open market from 1975 to 1996, Seyhun found that insiders, on average, have proved prescient. Stocks they bought outperformed the market by 4.5%. Stocks they sold went on to underperform the market by 2.7%.

BETTER ODDS? Seyhun has his doubters. Finance professors Josef Lakonishok of the University of Illinois and Inmoo Lee of the Korea Advanced Institute of Science & Technology also have studied insider trades and view their relevance more coolly. Says Lee: "If you try to invest every time on an insider trade, you will be very disappointed." Seyhun doesn't dispute that point. He concedes that "if the price has fallen after the insider has bought, or has risen after an insider's sale, those transactions don't have much [predictive power]." But Seyhun insists his findings can help investors improve their odds.

How should you follow Seyhun's findings? Under SEC rules,

several classes of insiders, including company executives, outside directors and large shareholders, own at least 10% of the stock, must disclose trades. Seyhun found that trades made by top executives, companywide responsible such as chief executives, chief financial officers, performed the broad market by the widest margin, 5% over a 12-month span. Lower-level executives and directors did somewhat worse, while big

Tracking Insider Trading

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stockholders' moves beat the market by just 0.7%. So if you care to mimic insiders' trades, focus on those of top executives. Among them, "CFOs are best," says Robert Gabele, research director at CDA/Investnet, a major supplier of insider-trading data. "They know the numbers," he adds,

and are less publicity conscious than chairmen and CEOs about their trading.

As with Ciena's \$18.5 million in aggregate insider trades last June, a cluster of many insiders either buying or selling heavily

in unison is a plain signal. But such cases aren't common, so Seyhun looked at how predictive individual trades of various sizes were. Trades of 100 shares or fewer, it turned out, didn't mean much. Trades of 1,000 to 10,000 shares beat the market by 4% over the ensuing year, and trades of 10,000 or more did even better. But just as trades by large shareholders didn't prove that informative, so were the largest trades of, say, more than a million shares not that helpful. Seyhun found that they beat the market by just 0.8% over 12 months.

The biggest trades often are made by corporate or institutional shareholders, and, says Jonathan Moreland, owner of the Web site InsiderTrader.com, "there are other reasons for their trading," such as corporate business strategy. Seyhun's rule of thumb: Individual trades become less and less meaningful as they grow in size past 100,000 shares.

RISKS. One of Seyhun's clearest conclusions is that mimicking insiders works best in small-company stocks. When he analyzed his data by company size, he found that insider trades in companies with market capitalizations under \$25 million beat the market over 12 months by 6.2%. That's twice as much as the next group of companies, those with market caps of \$25 million to \$100 million. Companies with market values over \$1 billion outperformed by just 1.7%, perhaps be-

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cause the market in their shares is more efficient.

For many investors, this creates practical problems: Trading volume in small-cap stocks often is low, and information about their prospects can be scarce, making investments in them more costly and risky. If you wade into small caps, Seyhun suggests protecting yourself by using limit orders, in which you specify a price at which you're willing to buy or sell, instead of the more common market order, which directs a broker to trade on your behalf at whatever price prevails in the market. The risk is that your trade won't get executed right away, but Seyhun found timing isn't critical. Even though 26 days typically pass between an insider's trade and its disclosure, "the reporting delays do not completely eliminate the profit opportunities," says Seyhun. "Good news for outsiders."

Overall, the soundest approach is to use a variety of factors in combination, Seyhun suggests. For instance, if you're not comfortable with trading small-company shares, focus on bigger companies, but look for those where top executives are trading blocks of 1,000 shares or more. Better yet is to combine fundamental investing criteria, such as price-earnings ratios, with insider-trading signals rather than relying on them alone. And diversify. It would take a portfolio of 50 to 100 stocks, Seyhun calculates, to

cut your risk of losing money.

One way to diversify cheaply is through a mutual fund that focuses on insider trading. So far, however, there's only one: Bear Stearns Insiders Select, which celebrated its third birthday recently. Senior Managing Director James McCluskey says the fund uses strong insider buying as the

first criterion of stocks to buy. For example, he recently bought shares of Dun & Bradstreet, whose chairman and CEO, Volney Taylor, purchased 25,000 shares in July. Before McCluskey buys a stock he also checks such traditional measures of value as low price to cash flow and price-earnings multiples. For all of Mc-

Cluskey's attention to insider filings and fundamentals, however, the fund has shown only mediocre performance. This year, it's down 4.7%, vs. an 8.4% loss for its benchmark, the Standard & Poor's Midcap 400 Index.

For investors keen on picking their own stocks, Seyhun's research strongly sug-

gests that it's worth paying attention to insider-trading disclosure. But "they should use it with everything is that they consider about stock," he adds. Happily, insider information is becoming more widely available via Internet, sometimes for free. Now, it may be easier to fathom, too. *Robert B.*

ZERO COUPONS, ZERO WORRIES?

If you think a prolonged stock market decline could force you to drastically

scale back your rosy retirement plans, you might want to take a look at zero-coupon bonds. Like U.S. savings bonds, zeros don't pay out any regular interest. Rather, you buy them at a deep discount to their face value and collect the principal—guaranteed by Uncle Sam if they're Treasury zeros—at maturity. Moreover, unlike coupon-paying bonds, you don't have to worry about reinvesting periodic interest payments at lower rates should rates continue to drop. "They're absolutely fabulous," says

Gerald Guild, chief taxable fixed-income strategist at Advest.

Most investors get into zeros via Treasury "strips", so named because the interest payments are stripped out by investment banks. Right

now, they return about 5.5% annually for maturities 15 to 30 years from now. While that's near a historic low, many bond mavens expect rates to fall further. But because zeros lack coupon payments, which can be reinvested at current rates, trading prices can be extremely volatile. For example, a \$1,000 strip maturing in 24 years yielding 5.5% now costs around \$272. If rates fall another 100 basis points over the next 12 months, the bond would be worth \$359. But if rates should rise 100 basis points, the bond would be worth only \$230.

If you plan to hold a zero until maturity, you won't need to worry about price fluctuations. For retirement savers, Guild recommends constructing a "ladder" of bonds maturing at regular intervals (table). That would assure you a specific income each year, beginning when



you turn 65, for example, and continuing for another 15 years.

TUITION PLAN. In addition to providing retirement income, zeros can fund other payments that come at a known date, such as a child's college tuition. But they have a major drawback when used in a

taxable account. Investors are required to pay each year on phantom interest accrued by the bond, even though they never actually receive any cash until the bonds mature. That's why it's wise to buy zeros in an individual retirement account for use when you want to withdraw the funds without penalty, typically after age 59½.

There is one loophole you can use if you want to buy zeros for a taxable account. Some AA-rated corporate zeros issued by Seariver Maritime and General Motors Acceptance Corp. enjoy a deferred status. Created in 1982 as an opening in the tax code that was subsequently closed, these securities have yields that are a bit higher than Treasuries, since they aren't backed by the U.S. government.

Even though this costs a bit more, don't buy zeros if you're worried about earning the absolutely highest yields. And since stocks have returned about 11% a year for the past 72 years, you should also allocate a portion of your retirement kitty to equities. But that decision ultimately depends on your risk tolerance. Indeed, zeros are best used to lock cash for the future and free you from worries about interest rates or the stock market. They aren't very flexible, but they can offer you some security. *Amey Smith*

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3 The strips start to mature when she retires in 2013. They will continue maturing annually through 2027, giving her a yearly income of \$42,000.

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COMMENTARY

By Adele Malpass

WHAT THE NASD RAP SHEETS DON'T TELL YOU

Too many investors have lost their savings to a bad broker, only to find out later that the rogue had a history of putting money in risky investments. The National Association of Securities Dealers (NASD) wants to help people avoid these bad apples by making disciplinary records of all brokers available on the Internet by early next year. But while the NASD's motives are admirable, the plan has a way to go before it's truly investor-friendly.

The NASD and state regulators already jointly compile a broker's job and disciplinary history into a rap sheet, known as a central registration depository, or CRD. Each year about 140,000 people call or E-mail the NASD to get broker records, even though less than 10% of brokers have any disciplinary action recorded (table). It now takes about a week to receive a report. Once the CRD database goes online, access will be immediate.

JARGON. The biggest problem with CRDs is they're loaded with jargon and acronyms. For instance, a report may refer to a fired broker as a CAF (for "censure and fire"). The NASD says it has a program to improve the reports. But even though CRDs now contain a simpler summary section, they're still difficult to fathom. As the NASD prepares to put them online, it should step up its efforts to use plain English.

An ongoing controversy is how much information to disclose about a broker's past. In recent years, broker groups have had some success in getting the NASD to water down CRDs. As of 1997, written complaints alleging sales practice violations involving damages of at least \$5,000 are reported for two years, then expunged from the public record. The same

goes for complaints alleging theft or misappropriation of funds. Previously, they were listed indefinitely.

Brokers argue that written complaints can be frivolous and often don't result in disciplinary action. But sales practice violations and theft are exactly the kinds of allega-

the record longer. Says NASD President Mary Schapiro: "It's a 'he said, she said' situation, and we're not in position to judge every complaint."

Over the next month, the NASD has a chance to move toward more disclosure. Brokers want the watchdog group to wipe out nonsecurities-related criminal violations more than 10 years old. Currently, anyone with a criminal record less than 10 years

old would have trouble getting registered as a broker. "We're trying to balance the public's need to know with the brokers' concern over privacy and how it will impact their lives," says Schapiro.

Brokers argue that old charges of pot smoking or driving while intoxicated are irrelevant. However, investors have a right to determine if something is relevant to their decisionmaking and the NASD should rule in favor of openness.

Even if the NASD decides to restrict the reports further, in most cases you can still get full, unedited versions by going to your state regulatory agency.

CRDs can screen out the worst brokers, but they don't

replace the due diligence you should perform before signing up with any investment adviser. A CRD won't tell you how well a broker's stock picks have performed, or if your financial goals match his or her style. To ferret out that information, interview the broker and do a thorough reference check. Still, getting a CRD is a vital step in determining if a

broker is right for your financial future. Now if only the NASD would recognize that fully and improve the quality and quantity of the information it's handing out.

Malpass writes about personal finance from New York.



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tions investors need to know about, especially because multiple occurrences would suggest a pattern of abuses. Instead of placing such a short limit on the time the complaints appear, the NASD should develop a process to eliminate frivolous claims, then keep the serious ones on



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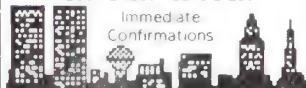
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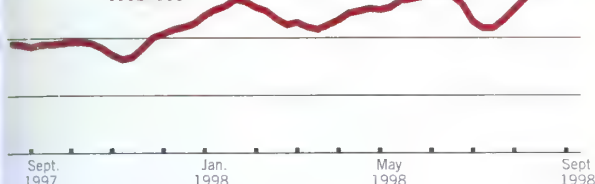
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Business Week Index

PRODUCTION INDEX

Change from last week: 0.4%
Change from last year: 5.5%

PRODUCTION INDEX
Sept. 12=136.6
1992=100



production index continued to climb in the week ended Sept. 12, while unaveraged index dipped 0.1% to 137.5, from 137.6. After seasonal adjustment, electric power was down 3.3%, with the largest decreases of stable energy in the Mid-Atlantic and Southeast areas. Rail-freight traffic, coal, and lumber output also fell, but that was mainly because of the Labor Day holiday. Auto, truck, and crude-oil production posted increases.

Production index copyright 1998 by The McGraw-Hill Companies

TRADING INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STOCK PRICES (9/18) S&P 500	1020.09	1009.06	7.3
CORPORATE BOND YIELD, Aaa (9/18)	6.37%	6.42%	-9.5
MONEY SUPPLY, M2 (9/7) billions	\$4,276.2	\$4,252.0r	7.7
REAL CLAIMS, UNEMPLOYMENT (9/11) thous	299	314r	-3.2
MORTGAGE APPLICATIONS, PURCHASE (9/18)	278.3	302.5	22.4
MORTGAGE APPLICATIONS, REFINANCE (9/18)	2,269.9	2,141.9	224.5

Sources: Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Bankers Assn. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
FEDERAL FUNDS (9/22)	5.38%	5.71%	5.45%
COMMERCIAL PAPER (9/22) 3-month	5.31	5.33	5.52
CERTIFICATES OF DEPOSIT (9/23) 3-month	5.42	5.43	5.59
FIXED RATE MORTGAGE (9/18) 30-year	6.84	6.85	7.52
ADJUSTABLE RATE MORTGAGE (9/18) one-year	5.73	5.65	5.66
LIBOR (9/18)	8.50	8.50	8.50

Sources: Federal Reserve, HSH Associates, Bloomberg Financial Markets

1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

THE WEEK AHEAD

MEETING

Monday, Sept. 29 ▶ The Federal Reserve's Federal Open Market Committee will meet to discuss monetary policy for the next seven days. According to the median forecast of economists surveyed by Standard & Poor's, the Fed is expected to raise interest rates. How- ever, policymakers are likely to shift their policy bias from a neutral stance to one tilted toward easing.

SUMMER CONFIDENCE

Monday, Sept. 29, 10 a.m. EDT ▶ The Conference Board's consumer confidence index fell to 130 in September, from 131 in August.

NEW HOME SALES

Wednesday, Sept. 30, 10 a.m. EDT ▶ New single-family homes probably sold at an annual rate of 880,000 in August, says the S&P MMS forecast. That would be down from the 886,000 sold in July.

LEADING INDICATORS

Wednesday, Sept. 30, 10 a.m. EDT ▶ The Conference Board's composite index of leading indicators was likely unchanged in August, after jumping 0.4% in July.

NAPM SURVEY

Thursday, Oct. 1, 10 a.m. EDT ▶ The National Association of Purchasing Management's business index likely fell to 49% in Sep-

tember, from 49.4% in August. A reading below 50% indicates that the factory sector is contracting.

CONSTRUCTION SPENDING

Thursday, Oct. 1, 10 a.m. EDT ▶ Construction spending probably rose 0.3% in August, on top of a 0.4% increase in July.

EMPLOYMENT

Friday, Oct. 2, 8:30 a.m. EDT ▶ The S&P MMS survey expects that nonfarm payrolls increased a healthy 200,000 in September. Jobs grew by 365,000 slots in August, but much of those were workers returning after the General Motors Corp. strike. The jobless rate likely remained at 4.5%.

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (9/19) thous. of net tons	1,899	2,074#	-12.0
AUTOS (9/19) units	114,161	106,856r#	-7.1
TRUCKS (9/19) units	122,921	112,797r#	-7.4
ELECTRIC POWER (9/19) millions of kilowatt-hrs	71,953	69,817#	3.0
CRUDE-OIL REFINING (9/19) thous. of bbl./day	15,051	15,420#	-0.3
COAL (9/12) thous. of net tons	21,785#	22,698	0.8
LUMBER (9/12) millions of ft.	418.0#	483.3	-14.7
RAIL FREIGHT (9/12) billions of ton-miles	25.5#	27.8	-3.4

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WWP1, SFP2, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (9/23) \$/troy oz.	288.900	288.250	-10.5
STEEL SCRAP (9/22) #1 heavy, \$/ton	85.50	85.50	-37.8
COPPER (9/18) ¢/lb.	79.4	81.1	-18.6
ALUMINUM (9/18) ¢/lb.	64.8	66.8	-16.2
COTTON (9/19) strict low middling 1-1/16 in., ¢/lb.	71.88	71.62	1.2
OIL (9/22) \$/bbl.	15.54	14.45	-21.2
CRB FOODSTUFFS (9/22) 1967=100	223.22	221.49	-6.9
CRB RAW INDUSTRIALS (9/22) 1967=100	277.85	280.11	-18.1

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (9/23)	136.55	135.05	120.13
GERMAN MARK (9/23)	1.69	1.69	1.77
BRITISH POUND (9/23)	1.68	1.68	1.61
FRENCH FRANC (9/23)	5.66	5.68	5.96
ITALIAN LIRA (9/23)	1666.0	1673.2	1732.3
CANADIAN DOLLAR (9/23)	1.53	1.50	1.39
MEXICAN PESO (9/23)*	10.123	10.035	7.816
TRADE-WEIGHTED DOLLAR INDEX (9/23)	111.4	110.7	106.0

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan

This Week, Online

Business Week presents frequent live conferences and chats on America Online—your opportunity to ask questions about timely topics.

Sunday

Martin Duggan of the Small Business Exporters Assn. tells how to get a piece of the global marketplace. **Sept. 27 9 p.m. EDT**

Tuesday

What is the stock market saying about the economy—and vice-versa? Ask David Blitzer, Standard & Poor's chief economist. The event is co-sponsored by S&P Personal Wealth. **Sept. 29 4:30 p.m. EDT**

Thursday

One way to plot investment moves: Track what corporate insiders are doing. Find out more from Jonathan Moreland of the Web site InsiderTrader.com. **Oct. 1 9 p.m. EDT**

AOL keyword: BW Talk

Transcripts of all conferences are available for downloading from the BW Online area on AOL soon after each event.



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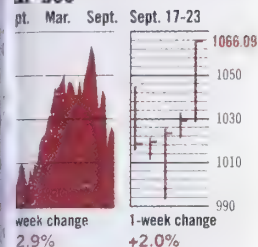
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Investment Figures of the Week

STOCKS

S&P 500



COMMENTARY

An encouraging week in the financial markets. The Dow Jones industrial average climbed 257 points to 8154.4 on Sept. 23. Investors were buoyed by comments by Fed Reserve Chairman Alan Greenspan, who seemed to indicate that he may push for lower interest rates. Financial markets advanced, with Citicorp and J.P. Morgan among the big gainers. The rally on Sept. 23 followed gains in the Asian, Latin American, and European markets. Internet stocks were also gainers, and the dollar rose.

U.S. MARKETS

	Latest	Week	Year
Dow Jones Industrials	8154.4	0.8	3.1
NASDAQ Combined Composite	1760.3	4.2	4.3
S&P MidCap 400	318.7	2.2	-3.3
S&P SmallCap 600	157.1	3.3	-15.5
S&P SuperComposite 1500	224.4	2.0	10.0

SECTORS

	Latest	Week	Year
Bloomberg Information Age	364.5	3.5	21.2
S&P Financials	116.9	1.0	4.8
S&P Utilities	253.3	1.6	22.9
PSE Technology	334.9	4.3	-1.2

FOREIGN MARKETS

	Latest	Week	Year
London (FT-SE 100)	5214.7	-1.5	2.7
Frankfurt (DAX)	4699.4	-3.3	14.6
Tokyo (NIKKEI 225)	13,789.8	-2.9	-25.1
Hong Kong (Hang Seng)	7504.4	-4.5	-47.2
Toronto (TSE 300)	6015.1	1.8	-14.2
Mexico City (IPC)	3902.2	14.3	-25.1

FUNDAMENTALS

	Latest	Week	Year
S&P 500 Dividend Yield	1.54%	1.52%	1.59%
S&P 500 P/E Ratio (Last 12 mos.)	24.4	24.7	24.1
S&P 500 P/E Ratio (Next 12 mos.)*	19.8	19.9	19.0
First Call Earnings Revision*	-5.87%	-5.20%	-1.48%

TECHNICAL INDICATORS

	Latest	Week	Reading
S&P 500 200-day average	1063.9	1062.0	Positive
Stocks above 200-day average	20.0%	18.0%	Positive
Options: Put/call ratio	0.67	0.73	Neutral
Insiders: Vickers Sell/buy ratio	0.66	0.80	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

BEST-PERFORMING GROUPS

	Last month%	Last 12 months%
HMOs	23.9	Broadcasting 65.5
Oil Exploration & Prod.	15.8	Drug Chains 63.1
Gold Mining	15.3	Drugs 51.6
Tobacco	8.8	Long-Dist. Telecomms. 50.7
Alcoholic Beverages	8.4	Food Chains 46.6

WORST-PERFORMING GROUPS

	Last month%	Last 12 months%
Machine Tools	-27.1	Oil & Gas Drilling -55.3
Metal & Glass Containers	-23.9	Leisure Time -47.9
Toys	-23.6	Metals -45.7
Soft Drinks	-22.8	Machine Tools -38.9
Invest. Banking/Bkge.	-22.5	Transportation Services -36.2

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness

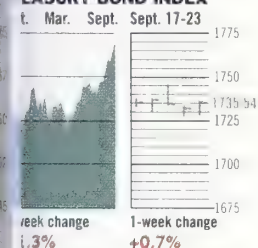
	Price	1-month change
Citicorp	95 1/8	-38 7/16
Intel	83 7/16	-1 1/16
IBM	127 3/4	-1 7/16
America Online	106 1/8	-2 1/16
BankAmerica	60 3/8	-18 1/16
Telebras-ADR	71 7/8	-12 1/8

Decline ahead? Stocks with most significant selling on price strength

	Price	1-month change
Dell Computer	60 1/16	1/2
Qwest Communications Intl.	34 1/4	2 55/64
Viacom-B	65 7/16	6 1/4
Adobe Systems	32 3/16	7 3/4
Centocor	40 3/4	1 9/16
Bank of New York	28 13/16	3/8

INTEREST RATES

EASURY BOND INDEX



KEY RATES

	Latest	Week	Year
MONEY MARKET FUNDS	5.06	5.09	5.14
90-DAY TREASURY BILLS	4.68	4.74	4.94
6-MONTH BANK CDS	4.86	4.97	5.17
1-YEAR TREASURY BILLS	4.59	4.78	5.46
10-YEAR TREASURY NOTES	4.67	4.88	6.04
30-YEAR TREASURY BONDS	5.17	5.23	6.32
LONG-TERM AA INDUSTRIALS	6.17	6.24	6.77
LONG-TERM BBB INDUSTRIALS	7.04	6.84	7.16
LONG-TERM AA TELEPHONES	6.60	6.70	7.10

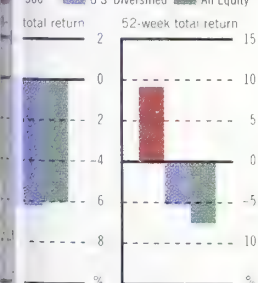
BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond		30-yr. bond	
	Latest week	Last week	Latest week	Last week
GENERAL OBLIGATIONS	4.16%	4.22%	4.83%	4.88%
PERCENT OF TREASURIES	89.16	86.64	93.45	93.41
TAXABLE EQUIVALENT	6.03	6.12	7.00	7.07
INSURED REVENUE BONDS	4.33	4.37	5.03	5.05
PERCENT OF TREASURIES	92.81	89.72	97.32	96.66
TAXABLE EQUIVALENT	6.28	6.33	7.29	7.32

MUTUAL FUNDS

500** U.S. Diversified All Equity



EQUITY FUNDS

Leaders	Four-week total return	%	Laggards	Four-week total return	%
Guinness Flgt. Mainld. Ch.	17.8		Vontobel Eastern Europ. Eq.	-31.9	
Fidelity Select Gold	13.0		American Heritage	-30.6	
Prudent Bear	12.2		Lexington Troika Russia	-28.2	
Fidelity Sel. Prec. Mets.	11.9		Fidelity Select Brokerage	-23.7	
Am. Cent. Global Gold	11.9		Montgomery Latin Amer. R	-23.0	
Leaders	52-week total return	%	Laggards	52-week total return	%
Smith Barney Telecomm. Inc.	40.9		Lexington Troika Russia	-88.9	
Fidelity Sel. Health Care	31.6		Matthews Korea I	-67.6	
Janus Twenty	31.1		Guinness Flgt. Asia Sm. Cap	-64.9	
Flag Investors Commun. A	31.0		Vontobel Eastern Europ. Eq.	-64.5	
Caldwell & Orkin Mkt. Opp.	30.9		Frontier Equity	-63.4	

EQUITY FUND CATEGORIES

Leaders	Four-week total return	%	Laggards	Four-week total return	%
Precious Metals	8.5		Europe	-12.2	
Natural Resources	0.9		Latin America	-11.3	
Health	0.1		Foreign	-10.0	
Pacific/Asia ex-Japan	-0.4		Diversified Emerging Mkts.	-9.2	
Utilities	-1.1		World	-8.9	
Leaders	52-week total return	%	Laggards	52-week total return	%
Utilities	15.8		Pacific/Asia ex-Japan	-50.6	
Communications	11.1		Latin America	-50.6	
Large-cap Growth	6.7		Diversified Emerging Mkts.	-46.6	
Health	3.8		Diversified Pacific/Asia	-41.1	
Large-cap Blend	3.7		Precious Metals	-36.1	

are as of market close Wednesday, Sept. 23, 1998, unless otherwise indicated. Industry include S&P 500 companies only. Fundamentals, technical indicators, Bloomberg mon-

ey flow analysis, and mutual fund returns are as of Sept. 22. For a more detailed explanation, write to us or E-mail figures@businessweek.com. NA=Not available **Vanguard Index 500 Fund

CORPORATE EARNINGS: TRUTH, PLEASE

It's amazing how fast investment psychology can change. Before July, when the bull market stopped in its tracks, Wall Street's mantra was steady "growth of earnings per share." Nothing seemed to matter but those rising quarterly earnings figures. After all, they enriched 401(k)s, fattened options, and created wealth for millions. Twelve hundred Dow points later, and lower, a new realism about the "quality" of those earnings is taking hold. For good reason. Fundamentals matter more when a rising tide isn't floating every company's earnings. They become critical when a profits recession begins to set in, as appears likely.

But investors looking for numbers that show the real picture may be searching in vain. Many corporate managers are stretching accounting rules like taffy to keep the bottom line moving up. Accountants are increasingly reluctant to blow the whistle for fear of jeopardizing remunerative consulting work. And analysts have morphed into cheerleaders and investment banking rainmakers. Truthsayers can get sacked. Just when investors need trusted information, the usual sources have turned fishy. What's going on?

While most attention is focused on accounting disasters that decked Sunbeam, Cendant, and Waste Management, the more widespread problem is the exaggerated use of ordinary practices. A favorite tactic: avoiding goodwill charges in mergers. Take in-process research and development write-offs, popular among high-tech companies that merge. In its \$37 billion purchase of MCI Communications Corp., WorldCom Inc. has announced plans to write off some \$6 billion to \$7 billion of in-process MCI R&D that may have commercial application down the road. Or not. Who knows, really? Yet the accounting maneuver lets WorldCom avoid huge charges for goodwill in the

merger that could have reduced earnings by \$100 million a year (page 134).

Taking "extraordinary" write-offs again and again is another tactic favored by managers. Since 1991, Eastman Kodak Co. has taken six extraordinary one-time-event write-offs totaling \$4.5 billion, equal to all the company's profits for the past 9 years. True, the write-offs stemmed from a dramatic restructuring of Kodak. Yet can a company have "extraordinary" one-time events for six out of the last seven years?

Then there is pooling-of-interest accounting, another merger technique. Pooling lets companies avoid goodwill charges by combining their assets at book value. Pooling boosted earnings by \$3 billion to \$4 billion when USA Waste Services Inc. and Waste Management Inc. combined in a \$16 billion deal.

All this is perfectly legal, but many of the accountants and analysts that investors expect to referee the game and protect them increasingly are playing for the other side. Many accountants are under pressure to go easy because their firms want to sell consulting services to the companies they are auditing. A number end up working for the companies they audit. Many analysts succumb to the pressure from the investment banking side of their businesses to pump initial public offerings and support corporate clients.

What is to be done? Investors can look to the growing number of new sources of company data on the Internet. At the least, they should temper the idea of Wall Street analysts as fair-minded observers. Accounting firms should separate their businesses cleanly or face shareholder lawsuits. And corporate CEOs should realize that the economic and financial world has changed in the past few months. Quality is valued when quantity can't be delivered. Let's get back to basics.

RECONCILING E-COMMERCE AND PRIVACY

Thanks to the Internet, personal service, once the province of the well-to-do, is increasingly available to the hoi polloi. It's now possible for Net businesses to tailor offerings to any individual's preferences, from gardening to investing. Do you like Chilean cabernets? How about military histories? One-on-one marketing has tremendous potential (page 164).

But not until the rules of privacy change. Most people assume they "own" the data of their everyday lives and should have the power to control it. Not on the Net, where the assumption is that data on people belong to whomever can gather the information, unless individuals specifically request to "opt out" of giving up revealing data. There are Web sites that demand personal data to register, then sell it or make it available to marketing partners without requesting permission. There are "cookies," pieces of software downloaded onto an individual's hard drive to track that person's online behavior. These practices defy deep American

traditions: individual liberties and ownership of property.

The solution is clear. Net commercial culture must change. Anonymity should be the baseline. Individuals should have an easy choice between "opting in" by providing data to vendors and marketers they trust, and "opting out" to retain privacy. It is up to businesses to offer incentives, such as discounts on personalized shopping, to make it worthwhile for people to give up personal data. If they choose, people must be allowed to surf the Web without being tracked. And they must have the tools to personalize the Web without revealing deeply personal information. A software group, the World Wide Web Consortium, is working on it, but progress is too slow.

The promise of customizing the sale of products and services to individuals is truly revolutionary. It marks a parting away from mass marketing and changes the nature of research, design, and manufacturing. But personalization can never reach its potential without protecting privacy.

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In the Quest for High Performance, So

By John Cafaro

If you're an automotive designer, there isn't a more challenging or, ultimately, a more rewarding assignment than to be given the opportunity



{ The new lighter, stiffer hardtop takes Corvette performance capabilities to the ultimate degree. }

to create the next Corvette. It's not something we take lightly. Great automotive design and Corvette have gone together since the very first one in 1953. It's about heritage, passion, tradition

and the future, all at once. And the fact that any new Corvette design must speak loudly of the performance potential that lies underneath the skin. The new Corvette hardtop would certainly have to measure up to some pretty lofty standards.

Our Future Must Start With Our Past. Our past is really important to the Corvette Design Team. Each and every day, we live and breathe Corvette history. Legends like the Corvette SS. The original Sting Ray. The '63 Coupe. The Mako Shark. It's all there for us to see whenever we turn a corner in the halls of our design studios. From memorable street cars and significant race cars to forward-looking concept cars and design studies, we feel the



{ Detailed aerodynamics: Like all Corvette mo

presence of every Corvette that ever before. Which is exactly why it's such to have the opportunity to design this Because as designers, we don't just new Corvette, we get a chance to ma



T h e N e x t C o r

BusinessWeek

OCTOBER 12, 1998

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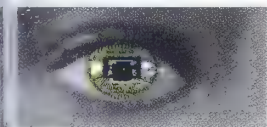
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High-Tech
Entrepreneur

Mark's
next big
idea



Silicon Eyes
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products that see



Perck
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machine
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going?



Working
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GLOBAL RISK

How to reshape the
WORLD FINANCIAL SYSTEM

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The fallout from
RIWETHER BLUNDER

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Sometimes you forget the million Sometimes you forget the



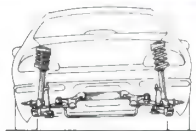
Whether you are going to
the store, to work or the dry
cleaners, every trip you take
in a Concorde LXi inevitably

***The Chrysler Concorde was respectfully ranked
"Best Premium Midsize Car in Initial Quality"
by J.D. Power and Associates.****

becomes a joyride. With every corner you become lost in
the stability of its cab-forward architecture and low-speed
traction control. As your thoughts begin to race, Chrysler
Concorde LXi's smooth 4-speed automatic, a fully adaptive
electronically controlled transaxle, actually begins to learn
your driving style and tailors its internal shift patterns for
you. Soon your fingers grip the leather-wrapped steering
wheel and your mind hums along to the purring sounds of a
225 hp 24-valve V6. Now then, where are you going again?
For more information about a test-drive you will never
forget, call 1.800.CHRYSLER or visit www.chryslercars.com.
Concorde LX starts at \$22,060. LXi as shown, \$25,785.**

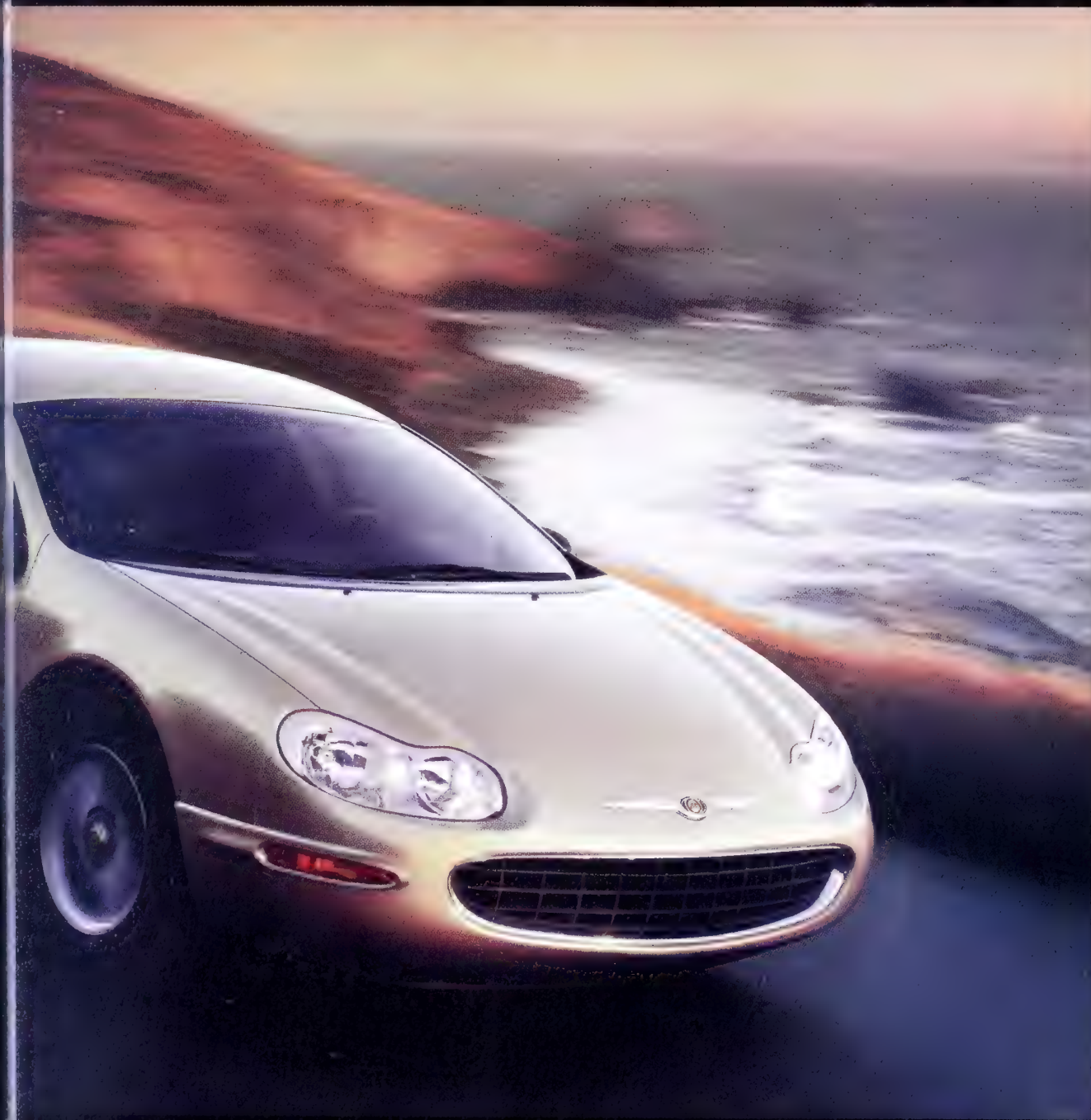


***Featuring MacPherson struts up front and
a multi-link configuration with Chapman
struts at the rear, the exacting geometry***

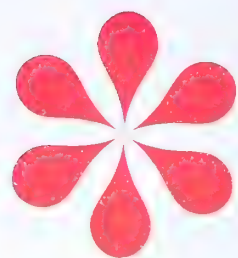


***of the Chrysler Concorde's precisely tuned
suspension reduces rear end squat under
acceleration and front end dive under braking***

**Sometimes you forget the bread.
The store altogether.**



CHRYSLER CONCORDE



It's in V
It's what
DigitatDNA
the 4th

It's in the baby monitor that lets you see her as well as hear her.
It's what makes taking her temperature as easy as taking her
picture—which it also helps you do. It's even in her favorite teddy bear.
Alas, it is nowhere near her poopy diapers.

 **Digital DNA™**
from Motorola

IT'S HERE.

BusinessWeek

OCTOBER 12, 1998

GLOBAL RISK

FIXING WORLD FINANCE

With hot money moving at cyberspeed, new tools are needed to curb speculation and maintain growth

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THE FED STEPS IN

But are its moves to ease the global crunch a case of too little, too late?

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Standards for measuring earnings must be stricter both here and abroad if the global economy is to thrive

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It's spending vast sums to attract resort customers who would normally go to Vail or Palm Springs

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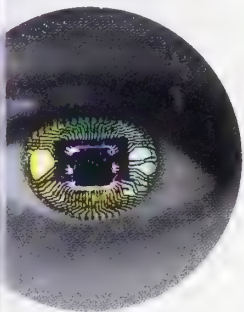
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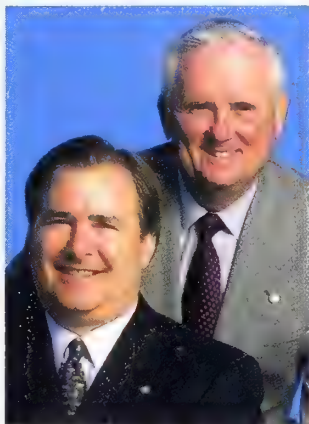
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okerage practice altogether

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CLARK'S NEXT ACT
in the founder of Silicon Graphics and
escape ring up another blockbuster?

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REAL-BOX KILLERS ON THE LOOSE
ew products and packaging are
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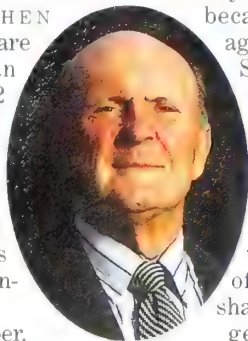
EDITED BY ROBERT McNATT

FUND WATCH

KNOCK TWICE, THEN SAY THE PASSWORD

AT A TIME WHEN hedge-fund losses are spreading, Julian Robertson Jr.'s \$22 billion hedge-fund group, Tiger Management, is trying to put the lid on the bad news—at least, as far as its numbers are concerned.

In late September, Robertson's offshore Jaguar fund shut down an automated telephone service, operated by its office in Curacao, that had provided callers with a daily tape-recorded update of the fund's performance. The shutdown comes in the wake of a widely reported decline of Robertson's funds.



ROBERTSON: *Silent Jaguar*

Tiger is up 14% year to date, after fees. However, its portfolios suffered a \$2.2 billion loss in late August and early September, in part because of a bet against the yen. (BW, Sept. 28).

Jaguar, which mirrors the performance of the other Tiger funds, is widely tracked by hedge-fund watchers. A Jaguar official said that shareholders can still get the latest performance data—but only if they identify themselves by name. "We just want to screen and ensure that we're only giving the NAV [net asset value] to Jaguar investors." Others, the official said, "might have been drawing incorrect conclusions" from the data. *Gary Weiss*

PAY CHECK

MYTH AND THE MINIMUM WAGE

ON SEPT. 22, THE SENATE nixed a Democratic proposal to again raise the minimum wage, with Republicans howling that it would be bad for small business. But surprisingly, small-business owners don't seem to agree.

That, at least, is the finding of a new study from the nonpartisan Jerome Levy Economics Institute at Bard College. The authors surveyed 568 commercially and geographically diverse small businesses and found that the most recent minimum-wage hike, from \$4.75 to \$5.15 per hour in September, 1997, affected

hiring decisions at just 6.2% of the businesses. At most of the affected companies, owners reduced new hires. Only 0.33% laid anyone off.

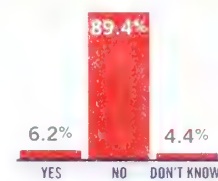
Even a raise to \$6, the survey indicated, would slow new hiring at just 20% of the companies. "It shows there's some room [for another increase], but there are also clearly limits," says Oren Levin-Waldman, one of the study's authors. Some experts say the survey avoids the pitfalls of other such studies by relying on employer responses

and not focusing on teenagers or food service.

The minimum wage currently totals \$10,712 annually—or \$2,090 below the poverty line for a family of three. *Edith Updike*

LITTLE IMPACT

DID THE RECENT INCREASE IN THE MINIMUM WAGE AFFECT YOUR HIRING OR EMPLOYMENT DECISIONS?



DATA: JEROME LEVY ECONOMICS INSTITUTE

TALK SHOW "It's unheard-of. I'm in awe of myself right now."

—Mark McGwire, after hitting No. 70.

SPORTS BIZ

THE NHL TRIPS OVER THE CANADIAN DOLLAR

CANADIANS HAVE A SPECIAL reason to jeer world currency markets. Pressure on their currency is taking a toll on the national pastime: ice hockey. The Canadian dollar skidded 12% in the past year before rebounding slightly in September, putting Cana-



OUCH! Slippery currency

da's six pro hockey teams in the penalty box. Why? The six pay players in U.S. dollars, but their revenue is

Canadian. The loonie—nickname of the Canadian dollar—is now worth only 66¢. "We've long been 30% behind the eight ball, now we're close to 50%," says an Edmonton Oilers spokesman.

The teams are waiting to see how much cash they'll get under the National Hockey League's currency-equalization plan, started in 1996, to address such problems. An NHL spokesman declined to say which teams would benefit, but added that up to \$5 million will be available "based on need." He wouldn't comment on a report in online newsletter *TheStreet.com* that Edmonton, Calgary, and Ottawa got money last season. But the pressure remains. While Edmonton has nixed a \$100 million offer from a Houston businessman, Quebec and Winnipeg have fled to the U.S. *Joseph Weber*

HONCHOS

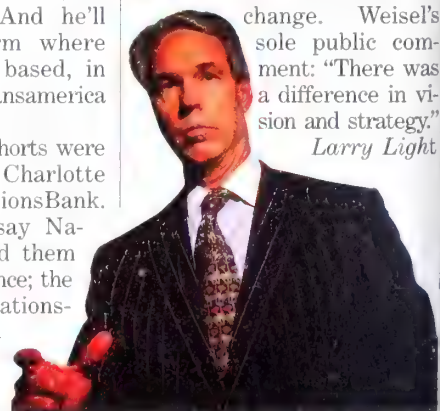
THE BEST REVENGE? MORE COMPETITION

THOMAS WEISEL, FORMER chairman of Montgomery Securities, will soon open a boutique investment firm following his angry departure from NationsBank, which paid \$1.2 billion for Montgomery. Weisel, says a source there, is also leaving with a \$100 million package. And he'll start his new firm where Montgomery was based, in San Francisco's Transamerica building.

Weisel and his cohorts were never happy at Charlotte (N.C.)-based NationsBank. Montgomery-ites say NationsBank promised them complete independence; the bank disagrees. Nations-

Bankers irked Montgomery types by tagging along on sales calls and also trying, unsuccessfully, to trim 5% off the firm's \$400 million annual-pay kitty. Weisel finally walked, friends say, when he lost control of Montgomery's junk-bond business to NationsBank's global finance chief, Edward Brown—who said he would quit if he didn't get it. The bank laments the resistance of "some individuals" to change. Weisel's sole public comment: "There was a difference in vision and strategy."

Larry Light



WEISEL: Bye-bye, NationsBank

LEHMAN BROTHERS

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September 16, 1998

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Up Front

BENEFITS BOOM

YOUR BUDDY MAY BE WORTH 30 GRAND

PSST... WANT A FREE, SHINY new 1998 yellow Volkswagen Beetle? Prefer \$30,000 hard cash? How about a trip to the Tour de France? All for doing practically nothing! Here's how: Get yourself a job at PriceWaterhouse-Coopers, then bring in a friend.

The global professional-services company is upping the ante in employee-referral rewards, with a level of prizes that Kevin Meehan, vice-president at benefits consultant Watson Wyatt Worldwide, calls "fairly unique." Credit the tight labor market. Brent Inman, a PriceWaterhouseCoopers

human-resources partner, says his firm needs 9,000 professionals this year. And because hires from employee referrals have high retention rates, Price aims to hike their number to 30% of recruits.

Here's how it works: Provide a lead on someone who stays in a director-level job for three months, and you'll get a \$7,000 bonus. You'll also get \$5,000 for a senior manager, \$3,000 for a senior staff consultant, or \$1,500 for support staff—plus a chance for a quarterly prize (a Tour de France or Outward Bound trip, and more). Finally, you'll qualify for the grand prize: \$30,000 or the Beetle. The first quarterly drawing is in October. So Price workers have nine months to salivate over that Volkswagen. *Joan Oleck*



GRAND PRIZE:
A yellow Bug

I-WAY PATROL

A POLITICAL SITE FOR SORE EYES?



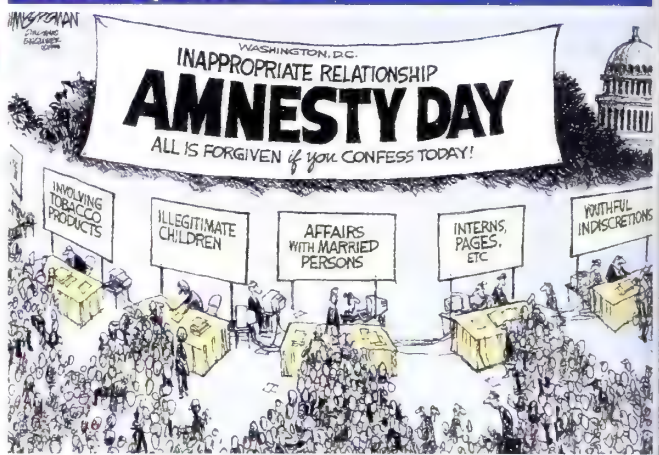
SOROS: Reform-minded

THE BEST THINGS IN LIFE aren't free, especially if you're running a political campaign. Publicity costs. Now, a new Web site called New York City Democracy Network (NYC Dnet), launched on Sept. 15, offers a no-cost forum for candidates in state and Big Apple races. Much of the credit—or blame—goes to

financier George Soros. His Open Society Institute (osi), which advocates campaign-finance reform in the U.S., contributed \$250,000. Earth Pledge Foundation, founded by labor mediator Theodore Kheel, worked with the Charles Revson Foundation and others to cough up \$250,000 more.

High rollers are welcome, too. Incumbent Governor George Pataki and Senate Democratic primary winner Charles Schumer of Queens have posted information about themselves; other pols have talked with constituents via message boards. And NYC Dnet is training librarians to use the site. So far, about 1,000 people a day have visited www.nyc.dnet.org. Says Mark Schmitt, osi public-policy director: "It's not enough to merely say you shouldn't be spending money on ads; you have to create other channels for communication." Hmm. Wonder if Congress is tuned in. *Heather Green*

DRAWN & QUARTERED



AFTERLIVES

THE BARD AS BUSINESS GURU

"TIS DEEDS MUST WIN THE prize." To Kenneth Adelman, that line from *Taming of the Shrew* is money in the bank—and career-saving advice for business execs. Adelman, a Shakespeare buff, former U.S. ambassador to the U.N., and arms-control negotiator, now puts on private-sector seminars featuring the Bard's works. For \$10,000 a pop, he, his wife, Carol, and volunteers from the audience don wigs and swords, speaking

snippets from *Richard III*, *As You Like It*, and other plays as training tools.

How can a 1500s playwright train 1990s corporate execs? Adelman, who teaches the Bard at George Washington University, explains: Say you're the leader determining how to react to the 1982 Tylenol poisoning disaster. You'd have been smart to listen to "An honest tale speeds best being plainly told" from *Richard III*. In fact, Johnson & Johnson did the right thing. But what about the future for Bill Gates and his expansion plans? Here's advice from *Henry IV, Part One*: "O the blood more stirs to rouse a lion than to start a hare." In short, aim high; it will help your company. *Robert McNatt*

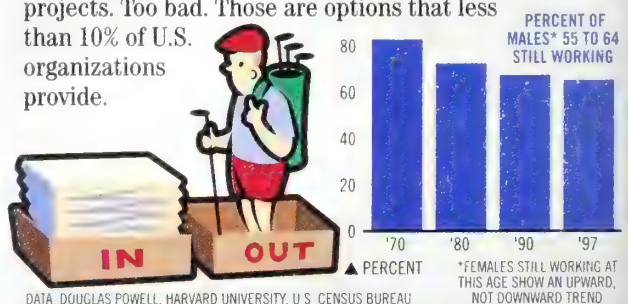
TO BE.... At Adelman's seminar



THE BIG PICTURE

NOT EVERYBODY PREFERS TO BE OUT FISHIN'

Older male workers are leaving the workforce earlier than ever. But most would like to work part-time or on special projects. Too bad. Those are options that less than 10% of U.S. organizations provide.





© 1995 American Plastics Council

It's true. In the last 20 years, empty milk jugs have lost a lot of weight. In fact, plastics are helping lots of products and packaging slim

product with less packaging. • Even the plastic grocery bag uses 70 percent less plastic than it did in 1976. Big deal? You bet. Now it would

Would You Believe The Jug On The Right Is 45% Lighter?

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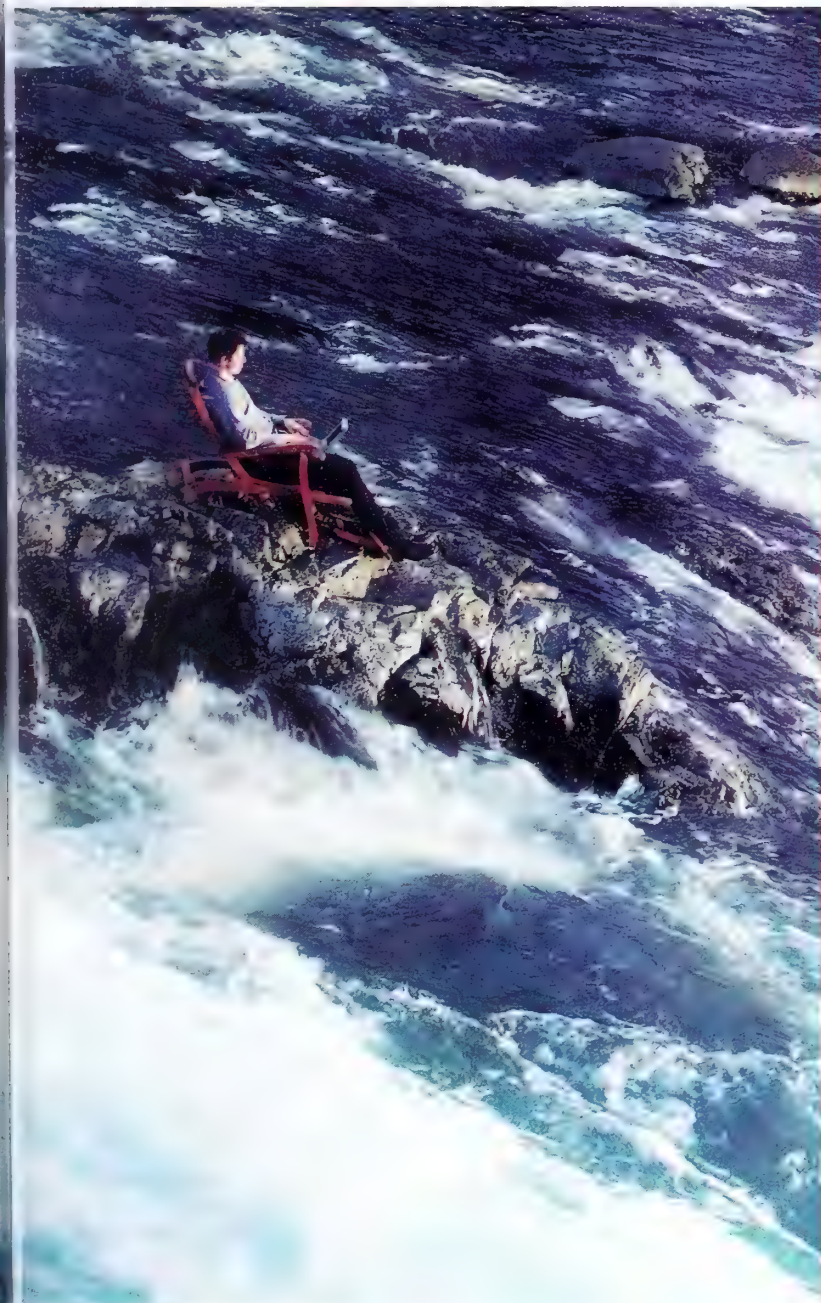
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IMPERFECT WORLD, IMPERFECT STOCK MARKET

In "Misfire" (Cover Story, Sept. 21), the recent dynamics of the market have reinforced a fundamental principle of investing: high risk, high returns. Quantitative investing attempted to dislodge that longstanding principle with "high returns with little risk"—but failed.

Dick Chaiet
Coconut Creek, Fla.

I am amazed at the things computer simulations can do: land a 757, make an unstable aircraft feasible (with 40 decisions per second), operate a chemical plant. But a decent engineer might accept the notion that some things are not predictable or quantifiable, and those that are might require a tuned response. How exactly does one factor in, or respond to, mass hysteria, tulip mania, or any number of chaotic events? Perhaps there's a problem related to collateral skills. I would feel more comfortable in an airplane designed by pilot-engineers.

S. J. Kavcak
Louisville

Your surprise at the failure of quant "rocket science" is a little disingenuous. The plain fact is that the sophisticated mathematical models for stock trading and hedging you describe are, by nature, corrigible—since however perfect markets may be, price systems always contain elements of randomness and perturbation. What mathematics can help traders to do is to establish optional strategies in a world of bounded rationality where conduct in markets reflects the way sane people ought to behave in a sane world. Introduce the insanity of market distortions due to errors of judgment (from federal or central bank authorities or firms themselves), and even models operating in

the most perfect and information-rich markets fail.

Blaming the math is like blaming horoscopes for a bad day—whether the horoscopes had inspired you to leave the house or shelter at home, you might still have had a terrible day. Here at University of Oxford, we are putting together a diploma to help "quants" get it right more often; we don't expect to be the solution to market makers' headaches, but we believe better math makes for better trading in the long run.

Mark Gray
Kellogg College
University of Oxford
Oxford, England



RISKY BUSINESS

"Introduce the insanity of market distortions... and even models operating in the most perfect and information-rich markets fail"

WHEN BAD MODELS LEAD GOOD COMPUTERS ASTRAY

Am I the only one who noticed the connection between "Misfire" and "Virtual management" (Management, Sept. 21) in the same issue? I wrote my first computer model in 1953. It slowly produced the wrong answer! Since it was a physical system we were modeling, it didn't take long to see that it was the wrong answer because we had a general idea of what the right answer should look like. It took much longer to figure out why our computer model didn't work. We decided that we didn't know enough about the details of the processes underlying the physical system we were trying to model, so we gave up.

It seems obvious that nobody will ever learn enough about the details of

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CORRECTIONS & CLARIFICATIONS

"Orderly growth, and no ulcers" (Personal Business, Sept. 28) incorrectly reported that the Vanguard Money Market Reserves Prime Fund is waiving expenses.

ow human beings will react to new (to them) conditions to build a valid predictive computer model based on such reactions, no matter how much statistical "history" was built into the model. I would never bet any of my own money on the results of running such a model, whether the model is pointed toward Wall Street investments or toward customer behavior patterns in a department store. I guess some people will never learn that just because "the computer says so" doesn't make it true.

Murray Lesser
Yorktown Heights, N. Y.

I wonder if others caught the irony between "Misfire" and "Virtual management." The cover story was all about the failure of software to make good investment decisions, while the management story was about developing software to make complicated management decisions. Forecasting anything means taking information we know today and using it to predict what will happen tomorrow. The concept is the same whether we are talking about the stock market or the retail industry.

There are two basic keys to good forecasting: being able to quantify stable cause-and-effect relationships and/or having a stable background environment for the relationships you cannot quantify. It would seem that the wealth of quantitative stock market data could make it possible to develop forecasting software that could outperform the market. But "Misfire" points out that just maybe the investment software gurus relied too much on a stable background for relationships that they could not quantify.

If we can't develop forecasting software for the stock market that can minimize embarrassments, then we couldn't expect to develop forecasting software that will eliminate embarrassments in the area of customer behavior. Can we develop software that will help us gain a better understanding of important factors? Absolutely, it doesn't expect a final answer from our computer.

Good companies already have a tool to safely test hunches and scenarios without major investments—and embarrassments." This tool is called "talk with your customer." Unfortunately,

ly, it is a tool that is not widely used.

Robert J. Chambers
Norcross, Ga.

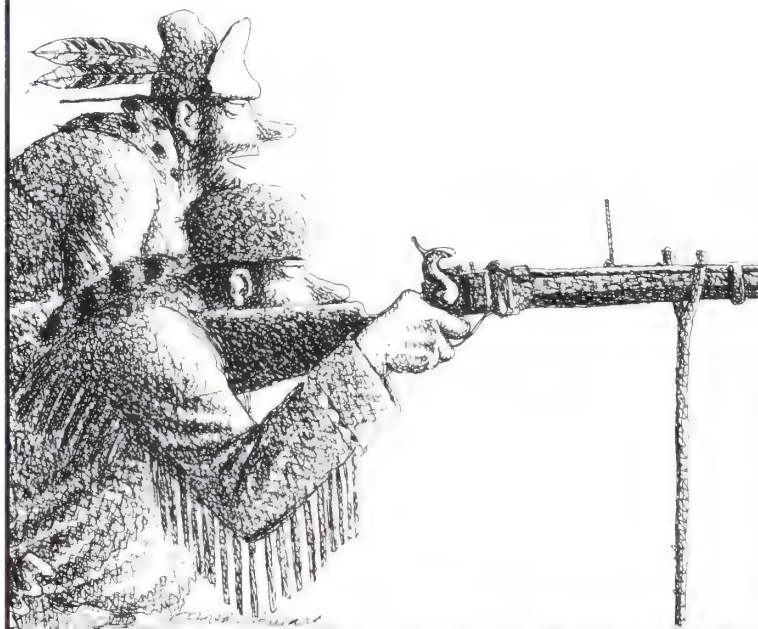
Thanks for giving prominent coverage to what has been viewed as a "far-off and far-out" development: management tools based on complexity science. But your readers should know that these tools are more within the reach of the average company than your article implies. For example, the ability Macy's is seeking—to use the computer

as a laboratory by running simulations of the behavior of complex systems—is already in place at Japan Central Railway. They use faster-than-real-time simulation to find the best solution to snafus on the line and work around them before any commuter is affected. Our own simulation work with Hewlett-Packard Co. focuses on the behavior of a crucial asset: the labor pool of knowledge workers HP needs to retain and recruit.

Moreover, simulation isn't the only

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business application of complexity science. We have seen it at Deere & Co. in a new approach to production scheduling, at Marks & Spencer in their credit scoring of charge-card customers, and in many other settings. In the longer term, the lessons of the adaptive-systems approach will change the way we view corporate strategy and organizational behavior.

Christopher Meyer
Director
Ernst & Young
Center for Business Innovation
Cambridge, Mass.

THE HOUSE HUBBY COMES IN MANY MODELS

In "The daddy trap" (Special Report, Sept. 21), you profiled five fathers and how they balanced their family and work lives. I enjoyed the article but was disappointed to find that while all three of the white fathers you chose to feature held professional positions in the computer industry, the Hispanic and African-American fathers profiled worked in service industries. While it is true that many minorities work in such positions, and I respect and honor their contributions to our society, it was disappointing to see that a magazine targeted primarily at professionals could not find a single minority manager or executive to interview as one of the five.

It is easy to disregard my concerns as just another example of "political correctness" (which I do not advocate). But editorial choices of this type inadvertently create subliminal messages that reinforce stereotypes about the professional limitations of minorities and, in this case, send them directly to the people who make key decisions affecting the careers of minorities.

Gerry Graux
Seattle

One of the fathers in your article, who actually sounded relatively conscientious, is quoted as saying, "To help out is just a natural thing." This well-intentioned remark delineates one of the clearest differences between a father's perspective and a mother's. No mother refers to herself as merely "helping out" with child care or housework. Child care is Priority No. 1, and housework is a critical—albeit ridiculous—marker of a woman's character. Most fathers, on the other hand, think that if they "pitch in" a little with these things, they deserve applause.

Additionally, as your story points out, when they begin to be stretched a little

thin, as all working mothers are, we suddenly learn that they feel "trapped." I would love to see our society come up with a way to value parenting and child care so that both mothers and fathers could do the best possible job of raising our children—and feel like productive members of society. But in the meantime, forgive me if I find this whining about "the daddy trap" more tiring than being mother to three children while pursuing a very demanding career.

Jane C. Hong
Racine, Wis.

Work-life balance is a misnomer. With average 10-hour workdays and two-hour daily commutes in metropolitan regions, there are but a few short waking hours for family and parenting. In an effort to fulfill career aspirations or achieve financial stability, some neglect the time and effort needed to devote to raising children. The importance of having a strong parental influence in the home has been diffused by dual-career families.

The marketplace has changed our society and should be held accountable. The corporate Band-Aid solutions mentioned in your article try to put quick fixes on a larger societal problem. I think it's time for our corporate, political, and thought leaders to realize one of the reasons that our children are violent in schools is a lack of parental leadership and involvement.

We should study other societies, in Europe and elsewhere, where the focus on the workday and family is quite different. Then we must implement drastic changes to our work environment and schedules so that our children will have the strength, ethics, and integrity we hope and dream they possess as successful citizens of our great society.

The schools continue to speak about the dearth of parental involvement; I don't think it's due to disinterest but more to a lack of time and energy. If we and our children are to compete globally, let's look at those societies whose children consistently outscore us in education and adopt family-centric lifestyles.

Peter Sobel
Scotch Plains, N.J.

The article hit right on track with issues facing working dads today. I have a 2-year-old daughter with whom I spend as much time as possible. My wife stays at home with our daughter, and I work while attending Auburn University's MBA program. I also help with chores and help take care of my daughter at nights and on weekends.

This doesn't leave much free time, but I don't feel as though it is a burden or a consuming activity. I enjoy it.

My family comes first in all decisions I make at work and at home. Where I work, travel considerations, and how many hours I am expected to put in, are a major consideration for my future after graduation. The simple things like eating together, taking trips to the park and zoo together, and playing together, strengthen the family bond. Sure, some things suffer. I get Bs instead of As, I make a little less money, I drive an older car, but so what? I am a happy person.

Perhaps if more men felt this way and were more inclined to spend time as a family, our future kids and grandkids might have a better chance at a more pleasant tomorrow.

Lee Conner
Auburn, Ala.

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Books

WORLD TRANSFORMED

by George Bush and Brent Scowcroft
 Knopf • 587pp • \$30

PRUDENT PLAYERS OF THE GLOBAL GAME

At the depths of the economic malaise of the early '90s, Democratic partisans circulated a wickedly funny T-shirt. On the front it declared: "George Bush went to Rome and all I got was this lousy recession." On the back, mocking the souvenirs of rock concerts, it advertised the President's "Anywhere But America Tour," with a long list of recent Bush destinations.

The tweaking T-shirt hit home partly because the 41st President did indeed refer the global stage to the domestic front. Like many in his generation, Bush was shaped by his experiences as a pilot in World War II and as a young adult at the height of the cold war. As President, Bush had an opportunity to witness firsthand, and to help shape, some of the most important moments of the fin de siècle: the collapse of the Soviet Empire, the fall of the Berlin Wall, and the birth

of a "New World Order" in which a new superpower takes on rogue states. He was far more impatient in dealing with what he considered the petty parsons of Capitol Hill and the political lizards of the Federal Reserve.

In the end, Bush's obsession with foreign policy, and his inability to convince most Americans that he understood their economic woes cost him reelection in 1992, to a Democrat whose campaign mantra was: "It's the economy, stupid." But the former President's global fixation has produced a memorable memoir. *A World Transformed* is unusual in any ways. It is an innovative joint memoir by Bush and his national security adviser, Brent Scowcroft. The two men alternating sections in the first per-

son. The narrative is woven together with third-person descriptions that they wrote jointly. And the text is supplemented with a series of revealing and heretofore unpublished excerpts from Bush's White House diaries and contemporaneous tape-recorded comments.

All of this sounds like a formula for a confusing jumble of a book. Happily for the reader, it is not. Bush and Scowcroft have put together a long but compelling look at some very important historical developments. While other participants, from Margaret Thatcher to General Colin Powell, already have weighed in with their own version of events, the Bush-Scowcroft tome is a valuable contribution to the record because Bush has for years kept so many of his own thoughts and conversations private.

Now, students of history can read Bush's secret letter to China's Deng Xiaoping, in which the President desperately tried to balance criticism of the bloody 1989 Tiananmen Square crackdown with admissions that the students had created "enormous problems" for those "required to keep order." Or the diary entry in which Bush admits that he wouldn't have been upset had Saddam Hussein been killed during a gulf war bombing raid. Bush's foreign policy team is exposed, warts and all. The book is remarkably candid, as well as occasionally self-critical.

A World Transformed focuses on four topics: the tense U.S. relations with China following Tiananmen, the decline and fall of the Soviet Union, the reunification of Germany, and the gulf war. Bush and Scowcroft choose to skip other international crises of the Administration, including the overthrow of

A WORLD TRANSFORMED



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Ianuel Noriega in Panama, the U.S. intervention in Somalia, the attempted coup in the Philippines, and the emerging Balkan bloodbath. The only important omission is the Yugoslav civil war, which may have been excluded because it wasn't a policy success.

Bush is obviously the central character in the book. Sometimes he is a keenly interested observer, sometimes a fatal participant in unfolding events. He prefers to move with caution, sometimes resisting bold moves because, in the words of TV impressionist Dana Carvey, they "wouldn't be prudent." He desires freedom for Lithuania and Ukraine, but he doesn't want to press too hard for fear of destabilizing Mikhail Gorbachev's regime. He wants to improve relations with China so much that he vetoes politically unpopular economic sanctions imposed by the Democratic Congress.

Bush's modus operandi on the global stage was personal diplomacy. He developed close friendships with key figures—Gorbachev, Deng, German Chancellor Helmut Kohl, French President François Mitterrand, Saudi King Fahd, Egyptian President Hosni Mubarak. These relationships helped Bush through some sensitive stretches, whether in building an anti-aq coalition or preventing Soviet intervention in Germany and Poland.

While Bush is clearly an expert behind-the-scenes diplomat, he also comes across as a public figure who never escapes the shadow of his charismatic predecessor, Ronald Reagan. On several occasions, Bush notes that he didn't possess the skills of the Great Communicator. Recalling his preparation for a televised address about the Persian Gulf tensions in August, 1990, Bush conceded: "I felt a little nervous. I held out my hand to see if it was shaking.... I knew I was not nearly as good as Ronald Reagan in these situations."

Scowercroft emerges from the book as a hard-line cold warrior and, along with vice-President Dan Quayle, one of the unchested conservatives in the Bush inner circle. He's constantly voicing his

suspicious of Gorbachev. While Bush is on a first-name basis with his friend Mikhail, Scowercroft cautions that the Russian is a dedicated communist trying to save a dying system. Scowercroft's sections of the book are well-written, and he's not afraid to admit when his analysis turned out to be wrong.

One quibble: The book devotes too much space (190 pages) to the gulf war. While the description of Administration efforts to mobilize the allied coalition is essential, the military strategy and details sometimes get boring. Readers know what happened. The value added by Bush and Scowercroft is their depiction of behind-the-scenes maneuvering.

With Bush's successor, Bill Clinton, enmeshed in a sex scandal, the ex-President is experiencing a renaissance of sorts in public opinion polls. As time goes by, Bush is sure to get more credit for helping eastern Europe (and perhaps China) move toward de-

mocratization and free markets. But *A World Transformed* shows the former President's limits as a geopolitical thinker. His biggest shortcoming: He doesn't focus enough on the economic implications of global change, thinking primarily in diplomatic and strategic military terms. And today, the key global tensions are economic.

As the 21st century nears, the sun is setting on the generation of world leaders molded by the 1940s. Bush, Thatcher, Gorbachev, Mitterrand, and Kohl all lost their jobs. A younger group of pragmatic wonks, such as British Prime Minister Tony Blair, is emerging.

Bush deserves his due. He guided the U.S. through a potentially treacherous period while avoiding a major confrontation with a dying Soviet Union or a recalcitrant China. He set an example for new-era international alliances in the war against Iraq. The economy may have cost him a second term. But as is obvious in *A World Transformed*, it has not cost him a place in history.

BY RICHARD S. DUNHAM

Dunham covers the White House for BUSINESS WEEK.

Bush's forte was personal diplomacy. He was close to Gorbachev, Deng, Kohl, Mitterrand, and Fahd

ONE BUSH REGRET: HE LACKED RONALD REAGAN'S CHARISMA



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STORY #7:

Meanwhile, Back at the Ranch

PRETEND you're an IS manager with a mobile sales force of hundreds and an endless trail of computers, components and configurations to follow. It's your job to (somehow) control them all—much like a modern-day herdsman. But keeping track of steer is one thing. Wrangling notebooks is quite another.

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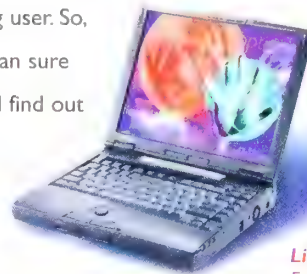
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BY STEPHEN H. WILDSTROM

LEGO'S LITTLE MIND-BUILDER

The toymaker's joint effort with MIT lets kids design a robot and program its brain

When my sons, now college students, were little, a favorite pastime of theirs was a Learning Co. game called Robot Odyssey. In this Apple II program, children (and adults) used various simulated sensors and circuits to build onscreen robots that could solve a set of progressively more difficult puzzles.

Robot Odyssey is long gone, but the idea is back, and you no longer have to settle for simulations using crummy Apple II graphics. The \$200 Lego Mindstorms Robotics Invention System is the result of a collaboration between the Danish toymaker and Massachusetts Institute of Technology's Media Lab. An earlier result of this joint effort, Lego Logo, has been used in elementary schools for a decade.

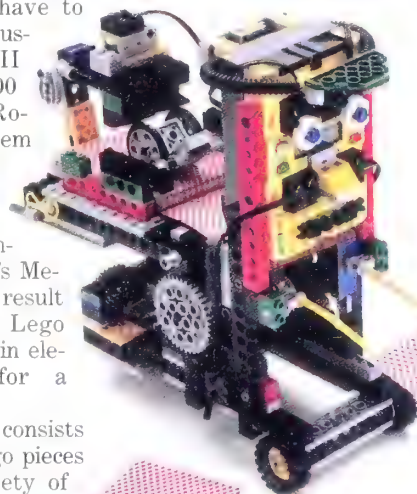
ICON EASY. The kit consists of more than 700 Lego pieces in a staggering variety of shapes, a programmable controller called the RCX, two motors, and touch and light sensors. You start by constructing a robot using the RCX as the core. Since my previous experience with Lego consisted mostly of stepping on pieces barefoot in the dark, I found this step frustrating. But I suspect the average 12-year-old could

manage it a lot better.

Once your robot is built, you turn to a PC for programming. Mindstorms' software, which runs on any Windows 95 computer, uses an ingenious technique. You build a program by connecting icons representing commands to build a string of instructions—no typing needed.

Although the number of commands is limited, they can create programs of considerable sophistication. A kid with no programming experience can write a routine

CHALLENGE: *Mindstorms Robotic Invention System*



that lets a robot respond to something, such as contact with touch sensors or a change in the light level. I wrote a program to get my robot to run an obstacle course.

Once a program is complete, you transfer it to the

RCX using an infrared link that plugs into a PC's serial port. Press the "run" button on the RCX, and the robot executes the program. If the robot doesn't work as expected—and it probably won't on the first try—it's easy to modify the code and try again. For example, I had to do a lot of testing to see how long to run the robot in reverse to back off from an obstacle before proceeding.

WEB HELP. One of the things I like best about the Lego system is the way it invites children to explore and innovate rather than just follow directions. A tutorial shows how to build a simple robot. The software then offers several design challenges, such as a robot that can run an obstacle course or one that follows a black line on the floor. Both the software and an accompanying pamphlet offer tips on how to construct the robot, but details are left for the builder to figure out. And there are lots of sample programs that can be modified. Lego (866 749-2291) also makes good use of a Web site, www.legomindstorms.com, for more tips and challenges. In addition, kit owners can get their own home page on the site where they can post their design ideas.

Some children will find this open-ended approach frustrating.

Others will find it stimulating. I think you have to know your kid before taking the plunge. The set should be in toy stores in North America and Britain in October, with Europe and parts of Asia planned for next year.

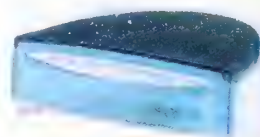
Like the long-ago Robot Odyssey, this robotics invention kit straddles the line between a toy and an educational product. I think that's a boundary where a lot of learning can take place.

BULLETIN BOARD

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FUN WITH USBs

About two years ago, PC manufacturers started putting Universal Serial Bus connectors on their desktop systems. But it wasn't until the USB-friendly Windows 98 went on sale this summer that PC owners had any practical way of taking advantage of the new attachment, which makes it much easier to hook up a wide variety of accessories to a computer. Win98, and the shipment a few weeks later of the USB-based Apple iMac, has triggered a flood of accessories, from printers and scanners to mice and even speakers. Owners of older PCs don't have



to feel left out. For about \$40, they can get a plug-in card from Entrega Technologies or ADS Technologies that will add two USB ports to just about any PC made in the past five years. These cards will physically fit in most Power Macintoshes, but so far, there's no software for them.

MORE PORTS TO PLAY WITH

It's also easy to add extra USB ports. Entrega, for example, offers hubs that plug into one of the USB connectors on your PC or iMac (including a version in the iMac's distinctive teal-and-white color scheme) and gain four (\$76) or seven (\$129) ports. An AC power supply ensures that the 2.5 watts of power called for by the USB standard are available to each of the ports.



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BY ROBERT KUTTNER

WHEN THE FREE MARKET IS TOO FREE



CONTROLS:
To stave off speculation, let's follow Chile's lead: Tax short-term gains and penalize early withdrawals of investment capital

How fitting that this century's second quest for a free-market utopia should be swamped by the gales of global financial turbulence. Financial markets are both the epitome and the bane of the laissez-faire ideal. They are as frictionless as you please, and thus prone to speculative ruin. The more global they are, the less they are regulated, and hence the more vulnerable to self-inflicted calamity.

While markets in, say, shoes are nicely self-regulating, financial markets are notoriously volatile. Even deep markets are no defense against herd instincts and leverage. In the laissez-faire 1920s, the result was the worst of both worlds—a chronic deflationary undertow coupled with bouts of speculative excess, followed by investor panic and then general depression.

Why both deflation and euphoria? An ungoverned global regime is deflationary because it relies on a gold standard or is operated in the interest of creditors or both. With a gold standard, the supply of gold artificially constrains real growth. In a creditor regime with free capital flows, nations pursue monetary austerity to attract investors. But a laissez-faire economy has no regulatory defense against destabilizing fads. Entire economies can be ruined by speculative bubbles.

Within a nation, government intervention can solve these problems. Macroeconomic policy can counter the deflationary influence of creditors. Regulation can temper speculation. Central-bank activity can contain financial panic. But globally, there is no regulatory institution strong enough to maintain stability. **COMMON GOAL.** In principle, the 1944 Bretton Woods pact remedied both speculation and deflation. Fixed exchange rates and limits on capital flows banished speculators from the temple. Central banks and treasuries made occasional changes in parities, but their common goal was stability, not profiteering from chaos. International Monetary Fund and World Bank credits helped shaky nations recover by resuming expansion, not by exporting deflation.

Today's World Bank and IMF, however, are a far cry from their originals, which were anchored by a more powerful U.S. dollar and a more activist U.S. government. With the relative weakening of the dollar and the collapse of fixed exchange rates in the early 1970s, Bretton Woods mutated into its antithesis—a system devoted to resurrecting

the reign of speculative capital and to enforcing austerity.

Now, with Asia's collapse and the imminent ruin of Russia, even bearers of conventional wisdom are having second thoughts. Longtime academic champions of free trade, such as Columbia University economist Jagdish N. Bhagwati and Massachusetts Institute of Technology's Paul Krugman, now find that financial flows are different from product flows and are not self-regulating after all. Advocates of exposure to global markets as a way of getting prices right are noticing that financial markets often get prices disastrously wrong and that China and India, which retained capital controls, are riding out the storm. Almost everyone faults the IMF's zeal for austerity. Clinton and Blair are rediscovering the "third way" of markets tempered by regulation.

HANDFUL OF SAND. People are also noticing that one size does not fit all. Russia lacks the civil institutions that are the prerequisite of markets; for Russia, the IMF is proving a dubious financial mentor and a worse democratic tutor. Japan's economy is in a classic Keynesian liquidity trap. The more it tries to stimulate spending, the more its anxious consumers stash away savings. East Asia has myriad structural problems. Generalized austerity only makes things worse, as does imported financial speculation. These countries need respite, not more exposure.

But nobody of real political influence is proposing a solution equal to the problem. Throwing some sand in the gears of speculative financial flows, in Yale economist James Tobin's famous phrase, would help. We could start by taxing short-term financial transactions and creating, as Chile did, a penalty for early withdrawals of investment capital to deter speculators. Both remedies are, of course, anathema to Wall Street, which still worships laissez-faire—except when a large institution fails.

Likewise, a global central bank more in the spirit of the original Bretton Woods could temper financial instability and restore a climate of high growth. But such a bank dominated by the present conventional wisdom or present notables would be worse than nothing. Before we get new institutions, we first need a painful reexamination of the most basic principles of this economic era. That rethinking has barely begun.

Robert Kuttner is co-editor of *The American Prospect* and author of *Everything for Sale*.

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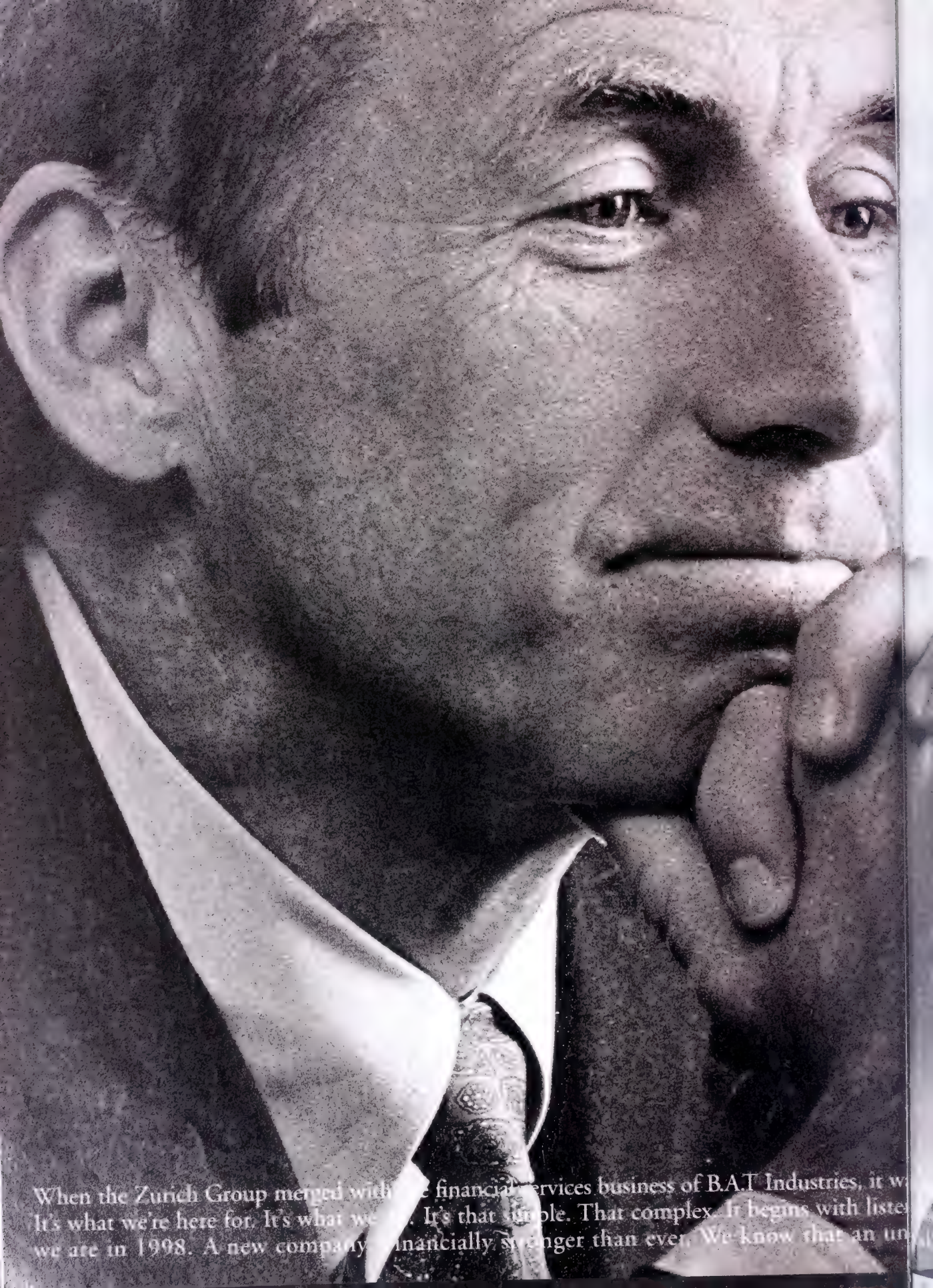
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BY GENE KORETZ

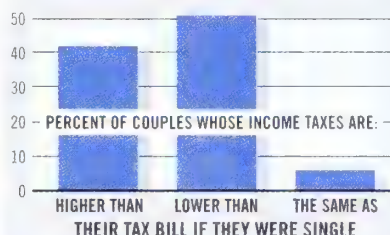
CONGRESS' IFFY WEDDING GIFT

The pros and cons of a tax break

Few ideas are more popular among Washington legislators in this political season than reducing the federal income tax code's so-called marriage penalty. Republicans have made it a major feature of the tax-cut bill just passed by the House of Representatives. Democrats have weighed in with several rival plans. The betting is that any tax cut plan that finally flies will take at least a modest step in that direction.

What's often passed over in the public debate, however, is that the current tax system is more biased in favor of marriage than against it. That is, for every four couples who pony up more in

MARRIAGE PENALTY OR MARRIAGE BONUS?



DATA: CONGRESSIONAL BUDGET OFFICE

income taxes than they would if each partner were single, five couples actually pay less. And those who benefit the most are "traditional" families in which one spouse is the main provider and the other's main energies are devoted to child-rearing and homemaking tasks.

A recent Congressional Budget Office study estimates that some 51% of couples filing joint returns wind up with marriage bonuses, compared with 42% who lose out because of their marriage status (the rest aren't affected). On a net basis, married couples paid some \$4.1 billion less in taxes in 1996 than they would if they had filed individual returns, with \$2 billion of the net bonus going to couples with adjusted incomes over \$50,000.

This pattern exists because past legislators wanted married couples with equal incomes to be taxed equally regardless of how much each partner earns, but they also wanted to hold down the gap between taxes levied on

single people and the taxes paid by workers with similar earnings who happen to be married. The upshot is that couples with relatively equal individual earnings now pay higher taxes than they would if they were single, but couples with relatively unequal earnings come out ahead.

Needless to say, it's the couples who pay higher taxes because of their marital status that have been griping. The challenge Congress faces in providing them with relief is to do so in a cost-efficient way without increasing the relative tax bite on single taxpayers. (Already, a single worker earning \$64,000 pays 42% more in income taxes than a married co-worker with the same pay and a nonworking spouse).

By that standard, the House-passed Republican tax bill falls short of the mark, says analyst Iris Lav of the Center on Budget & Policy Priorities, a liberal Washington-based think tank. By increasing the standard deduction for joint filers, the bill would provide relief to many middle-income couples, she notes, but it still wouldn't lessen the stiff marriage penalty facing some low-income working families who qualify for the Earned Income Tax Credit.

More important, the bill would actually increase the marriage bonus for many couples who already benefit significantly from the tax code. In the process, it would widen the already large gap between what single people pay and the taxes levied on married people with nonworking spouses. A similar proposal targeted only at couples facing marriage penalties could avoid this effect and cut the estimated \$6-billion annual tab in half, Lav says.

While singles have yet to be heard from, she adds, their numbers aren't small. About a fourth of adult Americans live alone, and single taxpayers file 58% of all returns.

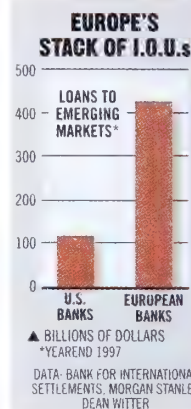
A TRANSATLANTIC CREDIT CRUNCH

Is Europe blind to danger signs?

Europe may be far more vulnerable to the widening world financial crisis than it believes, contends economist Stephen Roach of Morgan Stanley Dean Witter. The news that Switzerland's UBS bank just took a \$686 million charge to reflect losses on its exposure to Long Term Capital Management's hedge fund may be only the tip of the iceberg.

Roach estimates that European banks

had \$426 billion worth of debt exposure to emerging markets at the end of last year, equivalent to approximately 7% of the Euro region's gross domestic product. By contrast, U.S. banks' exposure came to \$117 billion, or just 1.5% or so of American GDP. Even in Latin America, Europe's exposure was double that of U.S. banks: \$133.6 billion, vs. \$64.3 billion.



DATA: BANK FOR INTERNATIONAL SETTLEMENTS, MORGAN STANLEY DEAN WITTER

The bottom line, says Roach, is that Europe may well experience a credit crunch as its banks write down their emerging market assets. What's really worrisome, he adds, is that European policymakers seem to be totally oblivious to such a possibility. And with economic growth in Europe running 2.5% on a year-over-year basis, compared with 3.5% in the U.S., it has a far smaller growth cushion should credit scarcity foster a slowdown.

THE WIDENING HEALTH-CARE GAP

Small-business cuts can't help

A sharp decline in health insurance provided by small businesses to their employees may be a major factor behind the rising number of Americans who lack such coverage (page 144).

According to a Dun & Bradstreet Corp. survey of owners and senior executives of small businesses around the nation, only 39% of such businesses in the U.S. offer health-care benefits to their employees—compared with 46% only two years ago. Since small businesses account for close to half of private-sector employment, the D&B survey appears to shed light on a recent Census Bureau report that the share of the U.S. population with no health insurance rose from 15.6% in 1996 to 16.1% last year, an increase of 1.7 million Americans.

D&B indicates that small businesses are cutting back on other employee benefits. Only 19% of firms surveyed said they offer retirement benefits, for example, compared with 28% in 1996. And only half of small businesses provide paid vacations for full-time workers.

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BY JAMES C. COOPER & KATHLEEN MADIGAN

WHY THE FED DIDN'T GO FOR A FULL-STRENGTH RATE CUT

While growth is set to slow, U.S. conditions don't call for stronger action

U.S. ECONOMY Call it Fed Lite. After thirsting for a full-bodied cut in interest rates, financial markets in the U.S. and around the world were very disappointed with the Federal Reserve's quarter-point trimming of its federal funds rate, to 5.25%, on Sept. 29 and its decision to leave the discount rate unchanged at 5%. The cautious move suggests that domestic concerns remain the Fed's primary consideration in setting policy. However, the fact that the bank moved at all implies that global turmoil influenced the Fed's decision.

To be sure, U.S. growth is set to slow, and that was a key reason the Fed acted. Consumers can't keep up their frenetic first-half pace, especially now that their confidence has slipped a little. And businesses are certain to curb capital spending in response to falling profits and costlier financing. Also, manufacturing output and employment will

continue to suffer, as exports weaken further (chart). But under normal circumstances, current economic conditions are far from dire enough to have provoked the Fed to trim the federal funds rate by even a quarter point. In fact, a slowdown that would halt the steady tightening in the labor markets is something that the Fed has wanted to see all year. Plus, there is yet no evidence to gauge the degree to which the economy is going to slow.

HOWEVER, THE FED'S ACTION suggests that these are not normal circumstances. The central bank seems to be saying, although not very loudly, that in an increasingly global economy, U.S. policy can no longer operate in the vacuum of the domestic economy. In addition, the rate cut appeared to acknowledge that the collapse of emerging markets is exerting intense pressure on pockets of the U.S. financial system. Only one week before the meeting, Fed officials mediated the \$3.6 billion bailout of the hedge fund, Long-Term Capital Management. The unusual intervention is seen as a Fed move to head off any systemic risks in the financial markets (page 40). The statement accompanying the rate cut said that

the Fed wanted to "cushion" the economy from increasing foreign weakness and less accommodative domestic financial conditions. In particular, a growing aversion to risk is causing less credit to be available. The Fed also said that because of "recent changes in the global economy and adjustments in U.S. financial markets," a slightly lower federal funds rate would be consistent with low inflation and continued growth.

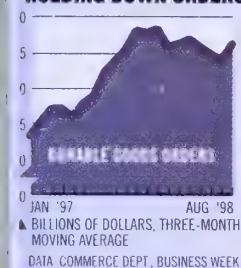
Still, the small move was not the shot heard 'round the world that many investors were looking for. The markets had held out hope for a half-point cut in the federal funds rate. And most Fed watchers were also looking for a half-point lowering of the discount rate, which could have held out the promise of more easing to come. However, nothing in the Fed's action or statement indicated that more cuts were in the cards.

ON PURELY DOMESTIC GROUNDS, the lower fed funds rate can be justified as insurance against a recession, especially since the global genesis of the expected slowdown is unique in the postwar era, making it more difficult to gauge the fallout. So far, signs of a slowdown are skimpy, but the latest one was the drop in September consumer confidence. The Conference Board's index fell to 126, the third decline in a row. The board said that global financial turmoil, a shaky U.S. stock market, and the President's uncertain future contributed to the sag in household spirits.

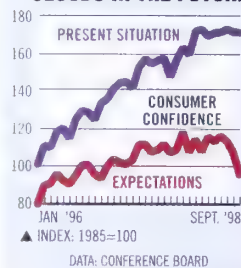
The decline in confidence was almost solely due to diminished expectations about the future (chart). Consistent with recent upbeat data on spending, consumers said that present conditions remained very near the best in three decades. However, the index of expectations dropped sharply. The three-month decline in expectations, totaling 17.5%, is the largest in five years. In the past, a plunge of that magnitude was typically followed by some slowdown in spending.

Any big pullback will not show up before the fourth quarter, however. That was clear from August's 0.5% jump in real outlays for goods and services. The increase followed a 0.3% drop in July, when car sales plunged due to the strike at General Motors Corp. and the end

EXPORTS ARE LIKELY HOLDING DOWN ORDERS



BLUE SKIES NOW, BUT CLOUDS IN THE FUTURE



of generous dealer incentives. But even with the July slump, third-quarter consumer spending is probably growing at an annual rate in excess of 3%, and excluding motor vehicles, the advance will be in the neighborhood of 5%.

However, households cannot sustain that frenzied shopping pace. That's because the nearly 5% growth in spending over the past year has exceeded the 3% clip of consumers' aftertax income (chart). Consumers have been able to supplement their buying power with realized gains in their stock portfolios. But those same gains meant consumers were less inclined to save. The August saving rate of 0.3% was the lowest rate on record, except for June, when the rate was zero. In coming months, the stock market's correction will force many consumers to save more—and spend less.

BUT CONSUMER SPENDING is not the economy's most vulnerable sector right now. That distinction goes to capital spending. Business investment in new equipment and buildings is getting hit from all sides. Profits are under severe pressure with little relief in sight. Weaker stock prices have lifted the equity cost of capital. New market assessments of risk have raised borrowing costs for all but those companies with the most sterling credit ratings. And the economic slowdown will cut incentives to expand already plentiful capacity.

Manufacturers' capital-spending plans are likely to

take an especially severe hit. Factories are already reeling from this year's plunge in exports, which is showing up in the weakening trend of new orders for durable goods. Factory bookings jumped 1.6% in August, but they have been volatile recently because of the GM strike and a bunching of aircraft orders. Excluding the transportation sector, August orders dropped 2.1%, and they are clearly drifting lower.

Capital-goods orders, excluding aircraft, are holding up fairly well through August, but the growth rates from a year ago in both orders and shipments of equipment have been slowing progressively throughout the year. With capital-spending fundamentals now increasingly negative, further slowing is a good bet.

A quarter-point rate cut won't do much to dampen those odds. And it was the weakness of the Fed's move that left the markets thirsting for more. However, the Fed likely recognized that economic growth is not yet easing enough to raise recession worries. And until policymakers see hints of severe slowing—or more chaos in the financial system—they will probably keep the full-strength rate cuts untapped.



COLOMBIA

REFORM MAY STILL RESCUE THIS ECONOMY

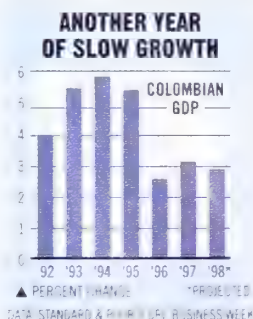
Latin America, a key source of U.S. export growth, continues to be hit by the Asian flu. One recent victim: Colombia.

On Sept. 2, its central bank devalued the peso, shifting its trading band to allow for an annual depreciation of 7% to 23%. The previous band allowed for maximum depreciation of 13% to 14% this year. Short-term interest rates, which had begun to fall, shot up as the bank squeezed liquidity to deter peso speculation. Rates are starting to slide, but remain high.

The central bank also lowered the foreign reserve requirement on borrowing abroad to 10%, from 25%, and cut the security's maturity to 6 months from a year. Those

steps could bring in more dollars and help lower rates.

But much of the damage is done. Real gross domestic product in 1998 will likely grow just under 3%—down from 3.1% in 1997



(chart), and less than the government's early-year target of 4.5%. And high interest rates are hitting construction, a key source of jobs. The jobless rate, 15.8% in June, may rise to 20% by yearend, some analysts say. Growth will be even weaker for

much of 1999, as fiscal tightening dampens domestic demand. But interest rates likely will fall next year, aiding growth later on.

The new government of President Andrés Pastrana is willing to

sacrifice a little growth next year to correct Colombia's troublesome fiscal deficit. The reform proposals before Congress include widening the value-added tax base, cracking down on tax evasion, cutting spending, and improving municipal tax collection. The government hopes the reforms will cut the fiscal deficit immediately, to a central government deficit this year of 4.8% of GDP, from a projected 5.2%, and a consolidated public-sector gap of 3.3%.

While Pastrana's efforts were applauded, congressional opposition means that the plan could fall short of its goals. A prolonged debate in Congress or only partial approval of the plan would fuel further attacks on the peso, likely forcing the central bank to keep rates high.

With Suzanne Timmons in Bogotá



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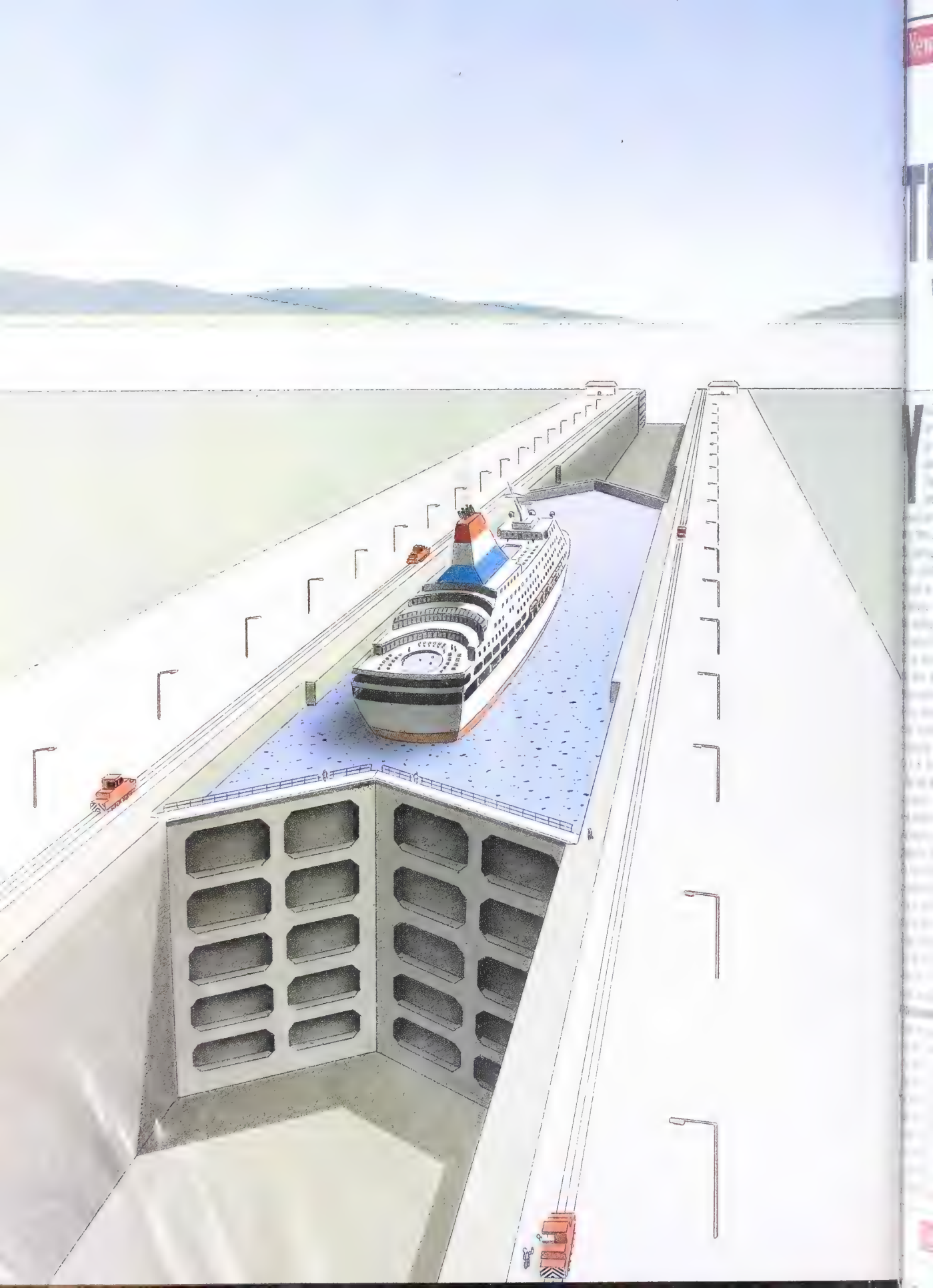
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THE FED STEPS IN: WILL IT WORK?

You'd think that Alan Greenspan & Co. would be lapping up the praise about now. After all, in the space of a week's time the Federal Reserve averted the U.S. financial system from a potential disaster by "catalyzing" a rescue of Long-Term Capital Management and followed up with a rate cut aimed at calming a global financial system reeling from emerging-market meltdowns. By helping head off the failure of LTCM, the Fed has prevented a large-scale panic that might have severely destabilized the already shaky credit markets, sending prices plummeting and perhaps even propelling the U.S. into a liquidity crunch. But this may not turn out to be much of a victory. Greenspan's Fed, which has been deified on Wall Street for policies that helped produce a 7½-year economic expansion, may have done too little too late this time. True, the Fed organized a bailout by 14 banks and brokerages, but it is perceived that LTCM's failure could be devastating. With markets still reeling from Russia's August devaluation, the Fed feared that a forced liquidation of LTCM would create massive financial instability, a Fed official says.

CROCOSM. Now, LTCM has quickly moved from financial neutron bomb to corporate orphan with 14 foster parents. But there are still concerns that other disasters are lurking. While many Wall Street executives insist LTCM was a one-off operation—undone by leverage and what other hedge funds would do—others aren't convinced. In fact, a Fed official privately concedes that he was surprised that there haven't been

The world is being drained of liquidity. America's moves to ease the crunch may not be enough

THE MONEY CRISIS

other blowups. Says Donald Denton, a general partner at Chilian Partners in Boca Raton, Fla.: "LTCM was a microcosm of every bank under the sun."

Indeed, on Sept. 30, shares of banks and brokerages fell again on worries about their exposure to emerging markets—continuing a slide that in three months has halved stock prices of many global banks. In addition, Chase Manhattan Corp. disclosed it had \$3.2 billion in loans and derivatives out to hedge funds—leading to speculation that other banks would disclose similar positions.

Nor are the bigger threats to the U.S. economy receding. With the spreading emerging-markets mess choking off demand and deflating prices, a parade of blue-chip companies including Coca Cola, Unocal, and Gillette (page 44) has issued dire warnings for third-quarter earnings. Many have started to rethink expansion plans, restructure, and lop costs. That, combined with early signs of evaporating liquidity in certain sectors of the economy, has some economists talking recession.

"The risk is a lot higher than it was six months ago, maybe on the order of 25%," says Mellon Bank Corp. Chief Economist Richard B. Berner.

That helps explain the lukewarm reaction to the Sept. 29 rate cut. Traders, who had bid up the market in anticipation, were disappointed that it wasn't larger. Instead of rallying, investors hit the exits, sending the Dow Jones industrial average tumbling 238 points, to close at 7,843 on Sept. 30th. They sought safety in Treasuries, which soared, leaving the 30-year bond with a yield of 4.97%, the first dip ever below 5%.

That was not a ringing endorsement of Greenspan's rate-cut agenda. Testifying before Congress on Sept. 23, Greenspan stressed that a rate cut might help inoculate the U.S. from the global mess. At the same time, the Administration was pushing lower rates as a way to relieve the pressure on struggling economies in Asia and elsewhere.

LONE MOVE. But markets around the world shrugged off the cut. One important reason: Despite efforts to coordinate rate cuts among Group of Seven countries, only Canada joined the U.S. action. That, says Michael J. Howell, managing director of CrossBorder Capital, a London-based investment firm, will dampen the effects of Greenspan's cut.

Certainly, many factors are beyond the Fed's control: The rest of the G-7 nations have other agendas. For instance, the new European Central Bank may keep rates high to prove its credibility and give the Euro a solid footing. And few could have foreseen the ruble crisis—and the ensuing virus that infected world debt markets,

WRONG MESSAGE? The rescue of Long-Term Capital w



leading to losses such as LTCM's. Fed officials say now that they were alert to heightened dangers after the ruble collapsed. Yet on Sept. 16, Greenspan was still calmly assuring Congress that there was no reason to be alarmed by the billion-dollar bets of hedge funds such as LTCM. "Hedge funds are very strongly regulated by those who lend the money," the Fed chief assured the House Banking Committee. Besides, "they are not all that large in the total context of the system."

Now, the Fed is taking the heat. LTCM's huge leverage was "a failure of banking supervision," says one top regulator. And the central bank's role in the rescue was "a huge mistake" that could encourage other funds to take big

risks, says a former senior Fed official.

The Fed declined to comment officially prior to an Oct. 1 congressional hearing on the LTCM matter. Privately, however, Fed officials are pointing the finger at the banks themselves. These lenders, they say, failed to accurately assess the risks they were taking on. The official stance is that the system works: The Fed watches over the banks and the banks manage their own risk.

In LTCM's case, though, that seems not to have worked. Bankers apparently fell under the sway of fabled trader John Meriwether—and the fevered competition to squeeze out some fat profits by lending late in an economic boom.

And neither the banks nor the Fed itself realized the total amount of leverage involved. Further, it didn't help that many of the lenders' top executives were investing their own cash in the firm. "It just takes your breath away that these great bastions of capitalism didn't do basic due diligence," says an Administration official.

SYSTEMIC RISK? With Congress hoping to adjourn on Oct. 9, lawmakers won't have time to launch any major effort to regulate hedge funds. But the LTCM deal has even conservative Republicans wondering whether Congress should put the brakes on the new world of finance. "If there was systemic risk and the Fed felt it had to step in to prevent contagion, then we have to step in with prudential regulation" of hedge funds, says an aide to House Commerce Committee Chairman Tom Bliley (R-Va.). And, says an aide to a GOP Senator: "Maybe we ought to look at whether the concentration of authority in the Fed is wise."

Other regulators are ready. Since May, for example, the Commodity Futures Trading Commission has been pushing to extend its authority over futures and options exchanges to cover instruments such as interest-rate swaps and other

GREENSPAN

Critics say the Fed failed to see that banks were making huge loans to risky hedge funds

over-the-counter derivatives. With LTCM's meltdown, "these issues—whether to impose reporting rules, capital ratios, or margin requirements—are all front and center now," says CFTC General Counsel Daniel Waldman.

But the CFTC's proposals "would not have prevented this event," asserts Securities & Exchange Commission Chairman Arthur Levitt Jr. Like Greenspan, he sees no need for additional oversight.

Behind the scenes there may be efforts to figure out how to curb excessive leverage and other

risky strategies. Regulators are especially concerned about banks' exposure to derivatives, many of them off-balance sheet. U.S. commercial lenders currently hold derivatives whose price are tied to assets with a value of \$28 trillion, according to the Office of the Comptroller of the Currency.

Meanwhile, neither the Fed's program to rescue LTCM nor its modest rate cut

THE MONEY CRISIS

huge mistake," says a former Fed official

as soothed the markets. From Japan to Russia and now Europe, prices are falling, credit is tightening, and markets are teetering. What's still needed, say many economists, is a concerted global effort to finally deal with the corrosive effects of the emerging markets meltdown. "A massive reliquefaction and restructuring of the world financial system is needed," says Howell of CrossBorder. **RIPPLING SPREADS.** Policymakers must figure out how to stop the free fall of developing economies—and get liquidity back into global markets. Since the Russian ruble tanked in August, investors have been recoiling from all but the safest securities. That has produced a widening gap—or spread—between the yields on Treasuries and other debt that is taking its toll with higher borrowing costs, plunging bond prices, and setbacks in investment.

The spreads can be crippling. For example, spreads on emerging-market debt relative to Treasuries reached 17% in mid-September and now stand at 11%, up from 6% when Russia devalued. Junk-bond issuance in the U.S., which was running at a healthy \$2.5 billion per week at the start of 1998, has wound to a virtual halt.

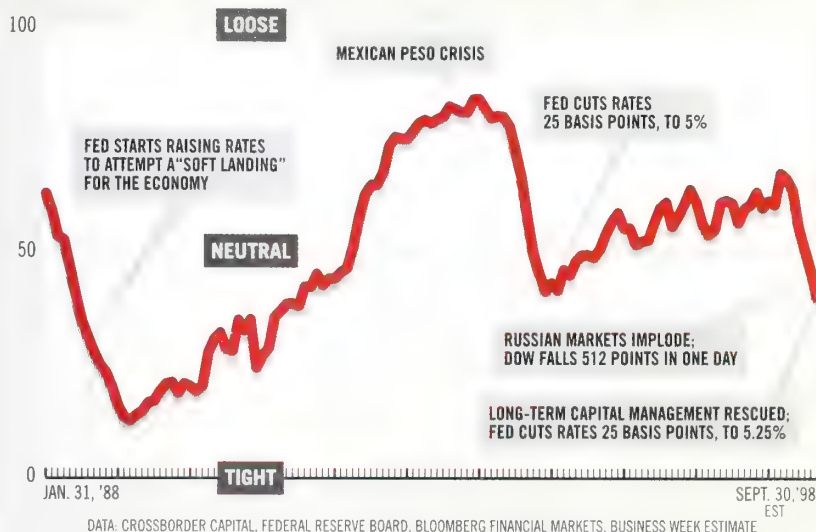
Equity financing is also getting tighter. After peaking at more than 50 deals a month during the summer, only four initial public offerings were able to fight their way to market in the U.S. in September, raising a measly \$91 million in total. Many would-be IPOs have been shelved. The most powerful sign of the times: On Sept. 28, Goldman, Sachs & Co. scuttled its long-awaited IPO, fearing a poor market reception.

Real-estate financing is drying up, too. New issues of commercial mortgage-backed securities, bonds backed by mortgages on commercial properties, fell from a high of \$11 billion a month in June to \$1 billion through Sept. 28. Issuers that want to get their deals done are having to offer buyers higher yields. For example, Nomura Securities Co.'s commercial mortgage-backed security division, Capital America, brought a \$1.25 billion issue to market the week of Sept. 25. Some over-rated parts of the offering aren't selling at all. And the AAA-rated issues are yielding 1.55% over the 10-year Treasury bond—double the risk premium on similar deals done at the beginning of the year.

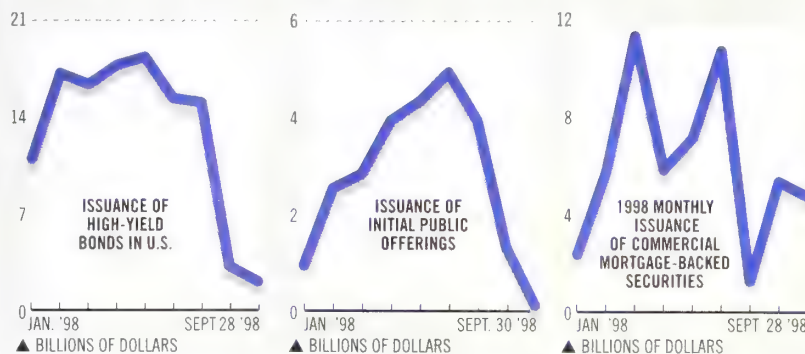
Real estate investment trusts, once a favored sector of the bull market, are

MARKET LIQUIDITY IS CONTRACTING...

INDEX OF LIQUIDITY AVAILABLE FOR INVESTORS, BASED ON MONETARY CONDITIONS IN 70 ECONOMIES



...AND THE PROBLEM IS SPREADING TO THE U.S.



finding themselves cut off from new capital, thanks to their fallen share prices. "You can't believe the number of deals that are falling apart," says Chicago financier Sam Zell. "We've got a serious, serious credit crunch."

In some quarters, tighter credit is a welcome sign—an indication that excess is being purged. The robust U.S. economy and soaring markets have attracted investment from all over the world. And that influx accelerated in the past year as other investment options appeared too risky. Flush with capital, banks, brokers, and hedge funds lent aggressively—perhaps too aggressively—both to businesses and consumers. In a September report, the Office of the Comptroller of the Cur-

rency warned that the competition among banks was leading to dangerously lax loan policies.

The tricky part is to squeeze out dangerous risk without choking the economy. Ridding the economy of dicey loans could backfire if it leads banks and investors into a wholesale retreat that pushes the economy into recession. That is the wretched scenario that has decimated most of Asia. So, here's the challenge for U.S. policymakers: Instead of lecturing the developing nations on how a well run capitalist system heads off economic disaster, show them.

By Kerry Capell in New York and Mike McNamee, with Paula Dwyer and Dean Foust, in Washington, Stanley Reed in London, and bureau reports

WALL STREET

THE RESCUE: WHAT YOU NEED TO KNOW

The Long-Term Capital Management deal is done, but questions remain. Herewith, some answers

Not since J.P. Morgan gathered fellow bankers at his offices at 23 Wall Street to stem the stock market panic of 1907 have bankers organized such an elaborate emergency bailout to calm nervous markets. On Sept. 23, some 91 years later, representatives of 14 major banks and brokerage houses got together at the Federal Reserve Bank of New York to deal with the collapse of Long-Term Capital Management.

The Fed hosted the meeting and may have done some behind-the-scenes arm twisting. But as in J.P.'s day, it was the close-knit club of Wall Street chiefs who exerted pressure on each other to pony up \$3.6 billion for the bailout. The deal got done because the firms were united in self-interest. They believed that it was necessary not only to protect themselves from big losses owing to their exposure to LTCM, but also from even bigger losses that could threaten the financial system.

But even as the historic private bailout was finalized on Sept. 28, many serious questions remain about why it was necessary and how the deal will work going forward. Here are some of them:

Can the consortium that controls Long-Term Capital Management dispose of the firm's \$100 billion in assets without further roiling the markets?

The consortium is giving itself three years to unwind the Long-Term Capital Management portfolio, plenty of time, they think, for an orderly liquidation. They assume that global markets will recover sufficiently during that time and that interest rates will move in their favor, allowing them to dispose of LTCM's positions, cut their losses, and even make a profit.

But dealers are already sitting on large inventories of securities acquired from LTCM. That makes it harder to sell many of the securities that LTCM holds. Already, financial institutions are shrinking their balance sheets and reducing risk capital, which backs their

THE NEW YORK FED: Twisting arms behind the scenes?

own proprietary trading and that done by hedge funds. Less risk capital means fewer



purchases of financial assets. At the same time, the leverage that is applied to the available risk capital has declined, meaning even less buying capacity. "Who is going to buy those assets?" asks a portfolio manager. "All of that paper has to be redistributed. It's going to put enormous pressure on spreads."

Were there any implicit or explicit guarantees or support offered by the New York Fed to the firms in the consortium?

It's possible the mere presence of the Fed made some participants feel they had better cooperate. But "it could be unique in my experience if there would be any quid pro quo," says Lodgin Cohen, a partner at Sullivan & Cromwell, which represents many of the banks in the bailout. Further, Deutsche Bank, which isn't even regulated by the Fed, ponied up \$300 million for the bailout. It's unlikely Deutsche would agree to lesser treatment than, say, Chase Manhattan Corp., which also put up \$300 million, if Chase was getting any Fed favor.

The main card the Fed has is subtle and very limited. If a firm doesn't participate in such an exercise, it may find itself out of favor with a powerful regulator. "If there is a margin call in the future, you may come out on the wrong side," says a banking source. Some sources speculate that Bear Stearns, which declined to participate in

the bailout, could encounter a frosty reception if it needed help from the Fed. Says one analyst, "[Bear Stearns] James E.] Cayne better hope he doesn't get in trouble himself."

Peter Bakstansky, a senior vice-president and spokesman for the Fed, denies that there were any implicit or explicit guarantees to rescue LTCM. "We don't get into the moral hazard business. We don't wink at bad loans," he says. "That's not how the world works."

In the midst of Fed-brokered negotiations with the consortium, Berkshire Hathaway, American International Group, and Goldman, Sachs & Co. agreed to buy out LTCM for \$250 million and commit \$3.75 billion to run-

ning the portfolio. LTCM did not accept the offer. Why?

Many market players say that LTCM's investments are ultimately winning positions. "It's like a poker player who has a really good hand but not enough chips," says David Berry of Keefe Bruyette & Woods. "The other guy keeps raising the ante and he can't stay in the game." Rather than accept

the offer from Berkshire, AIG, and Goldman, which valued the

portfolio at \$250 million and required LTCM chief John Meriwether to walk away, Meriwether and his team gambled on getting a deal that would leave them with a 10% equity stake and the opportunity to share in any upside. Since the consortium

agreed to inject \$3.65 billion for a 90% stake in

LTCM HQ: Meriwether and his team held out for a 10% stake



A Fed spokesman denies that there were any guarantees to rescue the company. "We don't wink at bad loans"

LTCM, their offer valued that 10% stake at about \$400 million.

Isn't there a possibility that the consortium of 14 investment and commercial banks will engage in illegal market practices—manipulation, collusion, frontrunning, or the like?

A spokesman for the consortium says that its agreement will put Chinese walls and barriers in place to prevent collusive activity. Some money managers say that consortium members may even quietly use their privileged information to bet against LTCM's positions, which could undermine any collusion. Others, though, are wary about this unusual arrangement. After all, an operating committee of six institutions, Merrill Lynch, Gold-

man Sachs, J. P. Morgan, Morgan Stanley Dean Witter, Travelers, and UBS will be allowed to share market information and even each have a representative on-site at LTCM's Greenwich (Conn.) headquarters. "It has the potential, if it's not managed properly, to be a huge collusive activity," says one money manager.

Some individuals in the consortium members have big investments in LTCM while their firms are participating in the bailout. Won't there be serious conflicts of interest?

There is the appearance of conflict. For example, Merrill Lynch & Co. CEO David Komansky had \$800,000 invested in LTCM through a fund of funds in his deferred compensation plan, while Merrill is putting up \$300 million for the bailout. And Merrill executives have a total of \$22 million invested in LTCM through the same deferred comp plan, which is now worth \$2 billion.

But this is an insignificant portion of Komansky's wealth. "Any suggestion that this relatively minor investment would motivate this decision is ludicrous on its face," says a Merrill spokesman. Komansky has much more riding on doing a good job as chief executive, and not just because he has \$100 million in Merrill stock alone.

Under the deal, LTCM and its investors will be allowed to keep 10% of the firm. Why should LTCM, which created such a mess, and its investors be allowed to retain any equity?

The thinking among consortium members may have been that a sliver of equity would keep the 14 partners who own Long-Term Capital Management involved in managing the bailout. But even if these men, including Meriwether, should make some money when the bailout is complete, some of the LTCM partners may have to declare personal bankruptcy, says a source close to the firm. The partners and some of their employees had all their money in the partnership, which was virtually wiped out. The partners made grievous mistakes, but even if they retain some equity, they have been subjected to a vicious punishment.

By Leah Nathans Spiro, with Suzanne Woolley, in New York



FINANCE

HOW THE GAME WAS PLAYED —AND WHY LONG-TERM LOST

Its computer models didn't foresee how bad bad could be

The rocket scientists at Long-Term Capital Management wrote the book on how to use derivatives. Now, they can write the sequel on how to misuse them.

Long-Term didn't make money the old-fashioned way, by searching out assets whose inherent value was not reflected in the market. Instead, it bet on the interior dynamics of the markets themselves: exploiting anomalies in the price difference between, say, two bonds with different credit ratings or between shares of merging companies. Instead of using derivatives to hedge against risk, Long-Term mainly used them as enhancers—amplifying its gambles and ultimately amplifying its losses when bets proved wrong.

As it pursued this strategy, the hedge fund in Greenwich, Conn., was able to make bets on the markets entirely out of proportion with its financial resources. And now the bailout of the fund is being hampered by the difficulty of unwinding these complicated investment plays that consist, mainly, of bundle upon bundle of these investment prod-

ucts known as derivatives—the squishy value of which is based on the worth of underlying securities.

What's shocking about the screwup is that no one should have understood derivatives better than LTCM. Partners Myron S. Scholes and Robert C. Merton shared a 1997 Nobel Prize in economics for options-pricing theory, the basis of the derivatives business.

To be sure, the exact positions that Long-Term Capital holds remain secret. (Anyone who knows what the new owners plan to liquidate could profit by betting the other way.) Still, the general outlines of Long-Term's strategy are known. Here, in a nutshell, is how it played the game—and how it was able to pile up such huge stakes that Wall Street and the Federal Reserve ultimately decided it was too big to fail.

Long-Term's favorite

bet was on the difference in the yield, or rate of return, between two debt instruments. Let's say that five-year junk bonds rated BB3 usually yield about two percentage points more than five-year Treasuries because of their higher risk. Long-Term's strategists might bet that if the yield spread ever got much wider than two percentage points, it was likely to narrow again soon.

Computer models would show that's a smart bet. But with the global economy in turmoil, investors lost their appetite for risk. Starting in July, they fled junk bonds and poured money into Treasuries. That pushed yields higher on junk bonds and lower on Treasuries. By late September, the yield spread

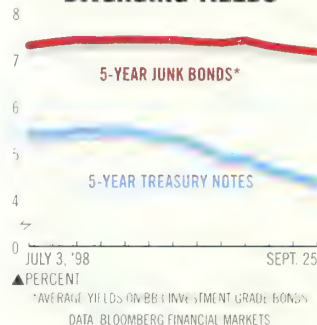
had widened to a punishing 2.8 percentage points (chart). Instead of converging, the yields diverged.

NO ONE KNOWS. Long-Term Capital made matters worse by using derivatives to increase the size of its bets without borrowing. For instance, it could have made a bet such as the one above without putting up a penny. Instead of spending \$100 million for a portfolio of junk bonds and shorting a like-size T-bond portfolio, Long-Term may have used a popular derivative known as a swap. In a swap, no money changes hands initially because typically the two parties start out by paying each other equal amounts. Long-Term would agree to pay the current yield on \$100 million of junk bonds and would receive in turn the current yield on \$100 million of Treasuries (plus some fixed percentage markup to make it a fair trade). The \$100 million is called a "notional amount" since neither party owns the underlying securities.

How much did Long-Term Capital risk? By some estimates, it had bets with "notional amounts" of \$1 trillion or more. But that overstates risks, since many of its positions essentially offset each other. While its balance sheet showed about \$100 billion in assets on a capital base of less than \$4 billion,

THE MONEY CRISIS

DIVERGING YIELDS



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its true risk came from derivative deals that don't appear on the balance sheet at all. The firms that took it over are still sorting out what they've inherited.

The beauty of a swap is that if the spread moves in your favor, you can make enormous profits without tying up any of your own money—in essence, your leverage is infinite. If the spread moves against you, though, you have to come up with correspondingly large amounts of collateral. Prudent firms won't enter huge swap deals unless they have capital adequate to withstand severe moves against them. Long-Term Capital's partners and its lenders apparently ignored that principle—or seriously underestimated how bad bad could be. Risk-assessment computer models “tend to ignore low-probability catastrophic events,” says Henry T.C. Hu, a law professor and derivatives expert at the University of Texas.

Still, how could one small firm's bad bets threaten the entire U.S. financial system, to the point where the Federal Reserve Bank of New York brought together 14 major financial institutions to bail it out? Simple: Not knowing how much aggregate risk Long-Term Capital was taking on, these same firms extended enormous amounts of credit because Long-Term had always paid off in the past. “It's a bit like a junkie with crack. You gotta have more of this stuff,” says a banking industry consultant. By mid-September, Long-Term owed so much money that its failure might have set off a worldwide chain reaction of creditors cutting off credit. In other words, a liquidity crisis.

Keeping Long-Term Capital on life support became even more important, since most derivatives aren't readily salable. One bet might employ half a dozen derivatives to hedge out various unwanted risks. Like the twigs in a bird's nest, each derivative is worth less alone than as part of a carefully built whole.

SHOT IN THE ARM. The injection of \$3.6 billion in fresh capital into LTCM will allow it to meet its margin calls, easing fears of a ripple effect. And Long-Term Capital's new owners will be able to keep many of the firm's core bets in place with hopes that convergence will ultimately make the bets pay off.

On the other hand, some important spreads have actually widened in recent weeks. The Federal Reserve's Sept. 29 rate cut should help. But if new margin calls and money-losing asset sales eat away too much of its current rescue package, Long-Term Capital might need to be bailed out all over again.

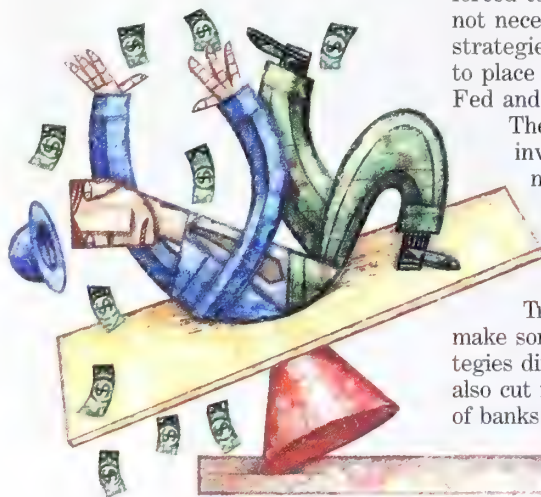
By Peter Coy in New York

COMMENTARY

By Gary Weiss

SLAP A LIMIT ON LEVERAGE—NOW

The hypocrisy of it is mind-boggling, even by Wall Street standards. Long-Term Capital Management, a piggy bank for the rich, makes a series of atrocious bets. Its managers, stern advocates of the free market when other people's fortunes are at stake, are bailed out in a Federal Reserve-engineered rescue that leaves them—astonishingly—still owning 10% of their firm despite their market-roiling mismanagement.



It's easy to lash out at LTCM and at hedge funds in general. And yes, new regulation is necessary—but not aimed randomly at the funds. Instead, regulators should focus on the high-octane “fuel” that powered LTCM directly into a brick wall. What is really to blame here is the excessive use of leverage, especially when investing in derivatives and currency. Whether such leverage be employed by a hedge fund or trading desks at a bank or securities firm, it is currently almost entirely unregulated.

The mistake would be to regard John Meriwether's brazen brainchild as representative of all hedge funds instead of a style of investing. Most of these private investment partnerships just buy and sell stocks at the levels of leverage available to all investors. Among the funds that use stocks alone, leverage is modest. According to figures compiled by Hennessee

Group LLC, a leading consulting firm for hedge fund investors, such funds beefed up their equity portfolios with leverage by just 32% as of January, 1998—a far cry from the more than 25-to-1 ratio employed by LTCM.

Such massive bets as LTCM placed can go cataclysmically bad. But they would be impossible if some limits were placed on leverage. Regulators need to ride herd by setting trigger points at which investors would be forced to disclose their leverage but not necessarily their investment strategies. Gauging precisely where to place the limits is the job of the Fed and other agencies.

These rules should apply to any investment vehicle doing business with U.S. financial institutions. This includes so-called offshore funds run by U.S. hedge funds and other trading firms.

True, limiting leverage may make some high-tech investment strategies difficult or impossible. It might also cut into the derivatives business of banks and Wall Street firms. If that's the case—well, so be it. LTCM's near-disaster proves that the risks from overblown leverage don't justify the rewards they can provide a few superrich traders and their bankers.

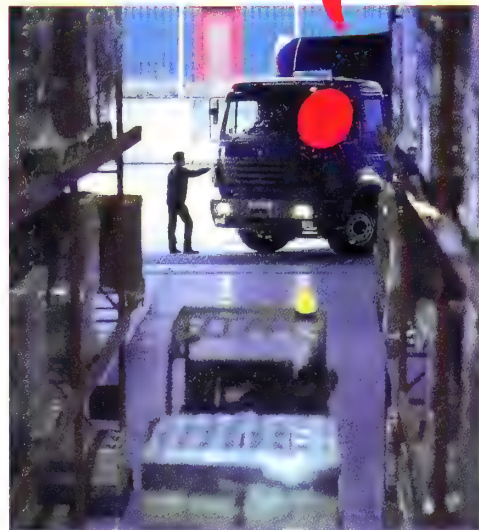
Seven years ago, one regulator pointed out that the market “is too important a national resource and it works too well to be put at risk by regulatory change for the sake of change.” That official was David Mullins, then vice-chairman of the Federal Reserve, who went on to become one of the brains behind LTCM. Mullins was discussing the Salomon Brothers bond-trading scandal, in which his future partner John Meriwether played a role. But while Mullins was right about inappropriate regulation, he should also recognize that the market is also too important to be placed at risk by the irresponsible excess of a few traders.

Senior Writer Weiss writes about Wall Street.

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CORPORATE EARNINGS

GILLETTE TAKES A SHAVE AND A BIG HAIRCUT

A \$535 million restructuring in the face of uncertain growth

Through the long bull market, Wall Street had a love affair with Gillette. And why not? The company steadily produced double-digit earnings increases, and often came within a penny or two of analyst forecasts.

No more. In a hastily arranged Sept. 29 conference call, CEO Alfred M. Zeien stunned Wall Street by conceding that Gillette's operating earnings in the third quarter would reach just 30¢ a share, 20% below 1997's level and 25% below the Street's consensus expectation. Gillette will also ax 4,700 jobs, close 14 factories, and close or consolidate some 30 offices worldwide. The resulting \$535 million restructuring charge—the largest ever at Gillette—will cut third-quarter results to no better than breakeven. The Gillette bulls are now in retreat: Its shares have dropped to 38, from 62 in July.

Even worse, Gillette's longer-term outlook is suddenly anything but certain. Zeien bravely suggests that Gillette "should be rolling again" in 1999, and he is not jettisoning his global ambitions. Still, even Zeien concedes that the emerging-markets crisis is "different than anything we've faced in the last 20 to 30 years," and "we don't know how long this is going to last." And since Gillette depends on markets outside the U.S. and Western Europe for 34% of sales, "no one really knows how Gillette will do," says Jay Freedman, an analyst at Lincoln Capital. "And if China and Brazil and Mexico go, it will be worse than the market thinks."

STIFF ARM. Gillette has compounded its problems by the way it managed the situation. For weeks, it stiff-armed inquiries from worried investors, even as the crisis spread from Asia to Russia and Brazil. Behind the scenes, Zeien was scrambling to contain the damage, in part by booking a gain on the sale of Gillette's Jafrá Cosmetics unit, which even he says he



COLD WINDS: Gillette's growth abroad has stalled

tried to time for the third quarter. But in the end, his efforts may have done more harm than good. "I used to think I understood what was going on at Gillette," fumes one analyst. "But now I don't know what to believe."

Zeien created more confusion by refusing to be specific about closings. Soon, staffers from the governor of Massachusetts' office were calling to check out a Boston radio report that the company would eliminate jobs at its "World Shaving Headquarters" in South Boston—despite the fact that Gillette just invested \$400 million in the plant.

Although Gillette's immediate problems stem from its overseas ambitions, it is not lowering its sights.

The restructuring is aimed at completing the makeover of Gillette into a truly global company. Each of six business units—from shaving to Oral B toothbrushes—will have worldwide responsibility for its own product development and manufacturing. Gillette will also consolidate several sales units. Zeien says this should save \$200 million.

But there is no global retreat. Even as he shuts factories, Zeien says he plans "huge capital expenditures to increase capacity in most product lines." At the same time, Gillette is gaining market share in some countries: Zeien says it now has 72% of the blade market in Russia and over 90% in Poland. Gillette is also shopping for acquisitions. Zeien notes that one troubled Korean battery maker already voiced a desire to be bought by Gillette. Even so, Gillette will face huge challenges in selling higher-price products in these depressed markets.

Gillette's woes have been compounded by the launch of its biggest bet for the future: the Mach3 razor. Even as overseas revenue falls off, Gillette

is accounting for some of the \$1 billion in startup costs in the early stages of the rollout, which began in late June.

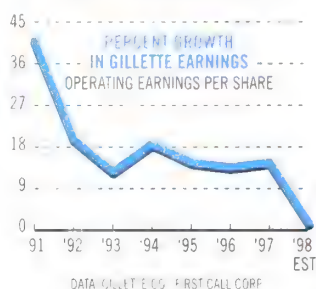
BIG MACH. Zeien is certain Mach3 is well on its way to stellar sales. He says it already has 17.6% of the U.S. shaving market. By 2002, he predicts Mach3 will be a \$2.5 billion business adding \$500 million a year to profits.

But that assumes a steady buildup from here. "Mach3 is still in the novelty stage," worries Jack Trout, a Greenwich, Conn., marketing consultant. Over time, "I'm not sure it is so dramatically better than Sensor" that U.S. consumers will pay a premium for it. And in the emerging markets, where Mach3 will debut in 1999, "they won't be selling a lot of expensive blades," Trout adds.

There's little doubt that Gillette will again enjoy vigorous growth—at some point. But for the first time in a decade there's uncertainty about when and how fast Gillette will return to its glory days.

By William C. Symonds in Boston

A DIP FROM DOUBLE DIGITS



THIS CHECKLIST CAN HELP PUT YOUR RETIREMENT PLANS ON THE RIGHT TRACK.

Did you know that your Social Security and pensions together account for less than 45% of all retirement income? The other 55% will have to come from personal savings, investments and earned income. If there's a gap, you'll have a better idea of what to do next when you've answered the questions on this checklist.

	YES	NO
1. Do you know how much you can expect to receive from Social Security and your company pension plan?	_____	_____
2. Are you taking advantage of pre-tax retirement savings by putting as much as possible into your company's 401(k) plan?	_____	_____
3. Are you saving enough to meet your retirement goals by investing in an IRA or annuity that grows on a tax-deferred basis?	_____	_____
4. Do you review your retirement strategies, savings plans and goals with a professional, to make sure you won't outlive your assets?	_____	_____



If you answered "No" to any of these questions, talk to a MetLife rep. We can give you the advice and information to help you develop a personal retirement strategy. To put your retirement plans on track, call us at 1-800-MetLife for our free Life Advice brochure, *Planning for Retirement*. Or visit our website at www.metlife.com.

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COMMENTARY

By Nanette Byrnes

NEEDED: ACCOUNTING THE WORLD CAN TRUST

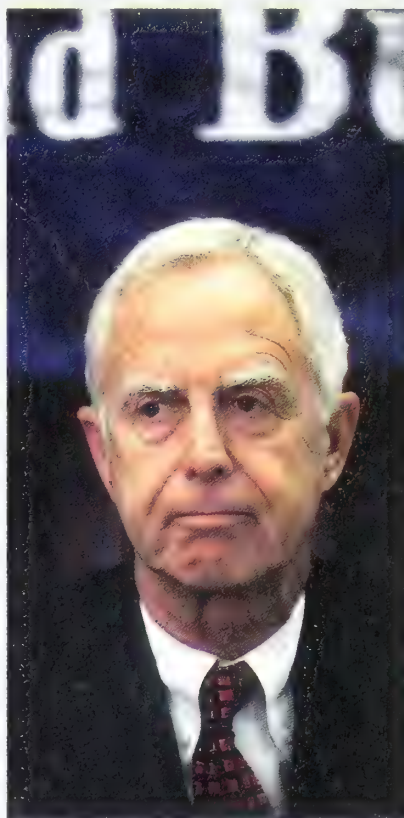
Don't believe what you read in those annual reports and quarterly earnings statements. That, in essence, was the message that Arthur Levitt Jr., chairman of the Securities & Exchange Commission, delivered in a Sept. 28 speech at New York University. Earnings accounting, he said, is a "game of nods and winks." His warning: "Integrity may be losing out to illusion."

Surprising words at any time, but coming at a moment of relative economic strength in the U.S., they are startling. As the domestic economy shows signs of slowing and pressure mounts to produce earnings by any possible means, Levitt has put companies and their auditors on notice: Think twice before playing accounting games.

But Levitt has a much broader community in mind in launching these salvos. By telegraphing plans for the U.S. to get even stricter about its accounting practices, he is laying the groundwork for rigorous financial reporting around the world—an important move as stock exchanges go increasingly global and lobbying accelerates for the adoption of more lax international accounting standards.

Levitt has picked an important moment to draw a line in the sand, as financial markets worldwide seek stability. The London-based International Accounting Standards Committee is mapping out new rules for global bookkeeping with the hope that the U.S. will sign on. Levitt's message: If you want to play with U.S. investors and raise capital in U.S. markets, then you have to play by tougher rules. "We're not going to embrace any standard that isn't as good as our own," Levitt insisted in an interview after the speech. "We're the best capital market in the world."

Who could argue with that? Not investors, who experienced the panic created in less transparent emerging markets as the enormity of the meltdown took many by surprise. Frederick D.S. Choi, dean of NYU's Stern School of Business, believes that the extent of the decline



in Asia, Russia, and Latin America was exacerbated by a lack of financial forthrightness and resulting skittishness among investors. "The market needs information on which it can assess risk," he points out.

Even so, Levitt's stance will certainly take plenty of heat—at home and abroad. U.S. corporations yearn for the day when either their foreign competitors are held to the same rigorous accounting they are or they will be let off the hook on U.S. reporting demands. And the stock markets, another powerful lobby, argue that the U.S.'s staunchly independent stance for tough standards has kept more foreign companies from listing here.

That's certainly not apparent when

one reviews the record number of foreign companies willing to comply with U.S. generally accepted accounting practices (GAAP) in order to trade on U.S. exchanges: 361 companies on the New York Stock Exchange and 455 more on NASDAQ. This is not always an easy decision for the foreign company. While adopting U.S. rules makes foreign companies easier for U.S. investors to evaluate, it also often makes them less financially attractive than they seemed under their own standards. Daimler Benz, which made

“We're not going to embrace any standard that isn't as good as our own. We're the best capital market in the world”

— ARTHUR LEVITT JR.

Chairman, SEC

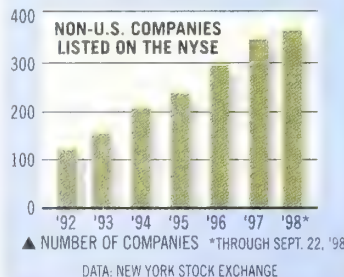
the decision to conform to U.S. GAAP in the early 1990s, for example, found its German profits disappear quickly into a net loss under our standards. Still, the opportunity to grab some U.S. investment money seems to be a potent enough enticement for many.

Levitt wisely recognizes this advantage. He also is smart enough to know that his battle for integrity will not be an easy one, even in

light of recent trillion-dollar hedge-fund blowups and international turmoil. "There's going to be enormous pressure," he says. "So we need everyone on our side."

Byrnes follows corporate accounting practices for BUSINESS WEEK.

FOREIGN COMPANIES COME TO U.S. EXCHANGES





ARTS AND MINDS:

Pricey rooms may not find many takers

will want to come to a place like the Four Seasons that has immediate name identification," says Glenn W. Schaeffer, president of Circus Circus. And despite the high prices, some Vegas resort owners point out the room rates are less than in comparable resorts in other states.

Even before the first of the new hotels opens, analysts are talking about overkill. "It's probably too much for the

market," says Michael French, a PriceWaterhouseCoopers partner in charge of the consultant's U.S. hospitality practice. "The question is, why spend \$200 a night when you can get a pretty great room at the Mirage for half the price?" Hotels—facing an occupancy rate down to 86% this year from 88% in 1997—are cutting rates. And even at Mirage Resorts—considered the most profitable of the operators, rates are expected to be down for the year, says Cowen and Co. analyst Hal Vogel. Still, he sees the Bellagio adding to Mirage's cash flow, although with much weaker margins—17% to 19% vs. 25% to 30% at other top city resorts. Predicts French: "Not every one of these hotels is going to be a winner."

NO GAMBLING? Those occupancy numbers persuaded Marriot International to rethink its next move: It postponed plans to build a 400-room Ritz-Carlton. And MGM Grand Inc. is also balking. "We're not sure there are that many resort customers out there," says MGM Grand President Alex Yemenidjian.

For the new clientele that the luxury resorts covet, gambling may not even be in the cards. At Circus' Mandalay complex, to keep the neon and clamor to a minimum, Four Seasons will offer customers their own, more dignified entrance—instead of trekking across the casino to check in as visitors do at most places on the strip. There won't even be a casino or slot machines anywhere in the five-floor oasis. But if resort owners are betting on finding loads of rich tourists looking for sun instead of neon in Las Vegas, it seems like a long shot.

By Ronald Grover in Los Angeles with Joe Weber in Toronto

TAKEOVERS

ELIZA MINNELLI, NEIL SEDAKA, AND... CLAUDE MONET?

Las Vegas is spending vast sums to draw upmarket customers

Forget Wayne Newton, Paul Anka, and Elvis lookalikes. The baroque marquee outside Las Vegas' brand new \$1.6 billion Bellagio Hotel reads: Coming soon—Van Gogh, Monet, Matisse, and Cézanne with special guests Pablo Picasso and Henri Matisse."

Scheduled to open Oct. 15, the 35-story Bellagio—modeled after the grand lake near Italy's Lake Como and boasting its own 12-acre lake with 1,200 synchronized fountainheads—marks a new section in Sin City's endless campaign to attract new customers: going upscale.

Still the capital of kitsch, the Nevada gaming mecca has been transforming itself into a Disneyland with gambling over the past several years. Now, it is wooing on the luxury-resort customer who usually heads to Palm Springs, Scottsdale, or Vail, Colo. Within the next 12 months, more than \$3 billion in new hotels will open alongside the glitz and glitter of the city's fabled Strip—offering spas instead of showgirls and five-star restaurants instead of \$2.99 buffets. It's a hefty wager: A raft of new hotel rooms has already driven down Vegas occupancy rates and room prices just as newcomers like the Bellagio want to charge \$200 and up.

Leading the charge, as he frequently does, is Mirage Resorts Inc. Chairman Stephen A. Wynn. It was the ostenta-

tious Wynn who introduced white tigers and exploding volcanoes to the Strip at his Mirage Resort in 1989. Now, the 56-year old casino king is bringing nearly \$300 million worth of art treasures to his new 3,005-room hotel. The Bellagio also features real Italian marble on the floors, New York's famed Le Cirque restaurant, and the requisite casino.

But Wynn is not the only hotelier chasing the resort crowd. In April, the \$1.4 billion Venetian, with 3,036 suites that it claims are larger than the average Bellagio room, will open. Offering its own 630-foot long canal filled with gondolas, it will charge up to \$250 a night. After that, Circus Circus Enterprises Inc. will open its \$950 million, 42-floor Mandalay Bay Resort & Casino, a South Pacific-themed complex. Within it is a 424-room Four Seasons hotel. "A lot of [visitors]

Viva Las Vegas, the New Luxury Resort

New construction on the Strip

HOTEL/ DEVELOPER	ROOMS	COST MILLIONS
BELLAGIO Mirage Resorts Inc.	3,005	\$1600
VENETIAN Sheldon Adelson, developer	3,036	\$1400
FOUR SEASONS Four Seasons	424	\$110*
PARIS Hilton Hotels Corp.	2,914	\$760
MANDALAY BAY Circus Circus	3,276	\$950

*Est.

DATA: LAS VEGAS CONVENTION & VISITORS AUTHORITY, BW ESTIMATE

COMPUTERS

PC MAKERS RACE TO THE BOTTOM

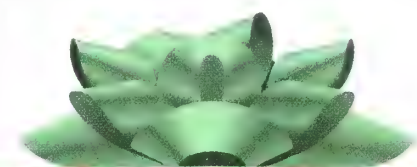
Prices keep sinking—but it's a risky game for manufacturers

Two years ago, little-known Monorail Computer Corp. helped spawn a revolution in personal computers. While larger competitors sought top dollar for machines with whizzy new technologies such as Intel's Pentium chips and Microsoft's Windows 95 operating system, Monorail sold machines for as little as \$999 in an effort to woo new price-sensitive users. PC giants Compaq Computer Corp. and Packard Bell NEC Inc. followed suit within months—and the PC business has never been the same.

Now, just in time for the upcoming holiday season, another industry pipsqueak is making noise—this time with a sub-\$500 PC. Emachines, a startup backed by Korean computer giant TriGem Computer and display maker Korean Data Systems, will unveil a \$399 computer—sans monitor—later this month. Sub-\$1,000 machines have pushed average retail prices across the PC industry from about \$1,600 to \$1,200, but prices are still too high to attract droves of new buyers. Emachines believes its E-Tower, which will sell for less than \$500 with a monitor, will appeal to the 55% of computerless households with annual incomes of \$25,000 to \$30,000. "This price point will open up another 20% of the market," promises Emachines CEO Stephen A. Dukker.

Analysts aren't convinced. But Emachines' pricing "certainly has some potential to drive penetration a bit higher," says Martin Reynolds, a PC analyst at Dataquest Inc.

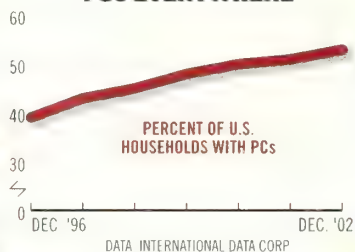
FREE PCs? Lower-priced PCs provide a glimpse of how the industry continues its shift from traditional desktop machines to ultracheap consumer devices. Analysts say the future is in "niche" PCs—some with specific functions for entertainment, others with financial applications or calendar-keeping. Some even anticipate what Webb McKinney,



EVEN LOWER PRICES...



...AREN'T PUTTING PCs EVERYWHERE



general manager of Hewlett-Packard Co.'s consumer-products group, calls "the era of the free PC"—when consumers could be given PCs by their cable or telephone company, which would then recoup the cost through monthly service fees. "These are the things that are going to carry computing to the masses," says Roger Kay, a senior PC analyst at International Data Corp.

Despite the price tag, E-Tower comes loaded with surprising power. It sports a Cyrix processor made by National Semiconductor Corp., a 2-gigabyte hard

drive, 32 megabytes of memory, a CD-ROM drive, a 56-kbps modem, 3-D graphics, and, for an extra \$95 after a mail-in rebate, a 14-inch monitor. Add \$59, and you get a three-year warranty and technical support.

Retailers have disdained cheap PCs in the past. While the machines have generated traffic, sales "haven't done well," says James F. Halpin, president and CEO of CompUSA Inc. Still, CompUSA and other retailers expect to stock a variety of cheaper PCs this season. By mid-November, Packard Bell NEC will slash the price of its entry-level machine to \$599. Even IBM and HP say they may sell machines under \$799. Sub-\$1,000 PCs could account for 50% to 60% of the industry's unit sales this holiday season, twice as high as last year, says an IBM spokesman.

"A BIT SUICIDAL." Dukker is in talks with retailers such as Best Buy Co. and OfficeMax to sell his computers. But he'll be selling them at close to his manufacturing price—and Emachines could wind up with losses if prices rise for components such as chips and disk drives. "That's a bit suicidal," says International Data's Kay.

Dukker, formerly a senior executive with Computer City, wants to add on goodies to his Emachine that will generate revenue and develop customer relationships. He plans to bundle each computer with an Internet access plan—launched by a Midwestern computer maker Gateway Inc., which lets some users pay monthly for their PC and software. He has cut a deal with Netcom On-Line Communication Services Inc. to give his customers Internet access and is negotiating a similar arrangement with an Internet "portal" company.

But will PC buyers want to form a relationship with an unknown? Experts say consumers are more comfortable buying big brands in everything from computers to cars. "We could all be driving Hyundais, but we're not," says Halpin. Emachines could be just another upstart with little hope of starting a price war. On the other hand, that's what they said about Monorail—when PCs were selling for \$1,600.

By Roger O. Crockett in New York with Peter Burrows in San Mateo, Calif., and bureau reports



**Are your
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together
by a network,
or tied up
by one?**

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COMMENTARY

By John A. Byrne

HOW TO REWARD FAILURE: REPRICE STOCK OPTIONS

How do you make outright greed palatable to disgruntled shareholders? Henry R. Silverman, chief executive of troubled Cendant Corp., seems to think that he and his board have found a way. Between April and late September, Cendant shares were ravaged, dropping from 41½ to under 12, by revelations of massive accounting fraud. The drop made most of Silverman's stock options look pretty unattractive. So, rather than take the hit, the board simply agreed to reprice over 17 million of them, cutting some strike prices in half.

Option repricing is hardly new, and with stock prices tumbling, many companies are tempted to lower the strike prices on executive option plans to current market levels. This is not going down well with some institutional investors, such as the State of Wisconsin Investment Board, which has lobbied nearly two dozen companies to put proposals to reprice up for a shareholder vote.

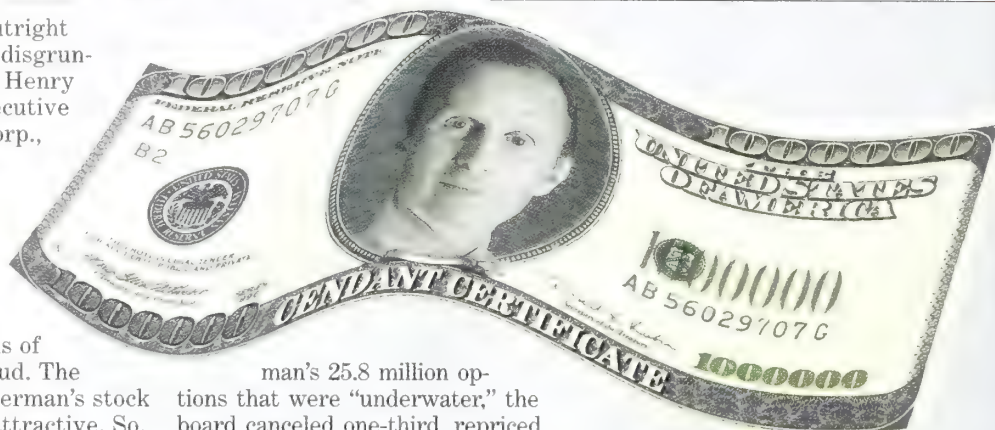
"SERIAL REPRICERS." Despite this opposition, repricing has picked up steam. In fact, executive pay consultant Graef S. Crystal dubs some companies "serial repricers." Apple Computer Inc. has the dubious distinction of topping this list, having reset option prices nine times in its brief life. Advanced Micro Devices Inc. has repriced a half-dozen times; Cypress Semiconductor has done it five times, including twice in one week back in the late '80s. Admittedly, high-tech companies, which use options to lure talent, need to keep options attractive. More recently, though, companies like retailer Winn-Dixie are getting into the game.

To disarm the most vocal critics, Cendant added a new wrinkle. First, the company pulled a Washington trick: It floated a trial balloon to see how shareholders would react. Without major opposition surfacing immediately, it went forward with a novel game plan: Rather than reprice Silver-

man's 25.8 million options that were "underwater," the board canceled one-third, repriced one-third at current prices, and repriced the final third at a 50% premium. Even Crystal, a vociferous critic of repricings and excessive executive pay, has been mollified. "Other companies will look to Cendant as an example of how to do [option repricings] the right way," he says.

For the sake of shareholders everywhere, let's hope they don't. The accounting debacle at Cendant, in which some former execs have been accused of fraudulently inflating income by \$500 million over three years, has cost Cendant shareholders nearly \$26 billion. Although Silverman doesn't appear to be directly responsible for the accounting games, he acquired the company and management now being blamed for the disaster. "It was the lack of due diligence that caused the stock to crash," insists Charles M. Elson, a professor at Florida's Stetson University College of Law. "Repricing his options is effectively rewarding him for failure. The shareholders don't have that option for their investment. Why should he?"

It's a good question. Silverman, who didn't own a single share of Cendant outright, didn't suffer any real loss. He already had absurdly outsize stock-options grants on 46.3 million shares,



SILVERMAN:

His losses were only on paper

which once gave him a theoretical net worth nearing \$835 million. His "paper" losses of some \$600 million are just that. "You'd like to see Silverman share some of the downside risks that shareholders have already been asked to bear," says Patrick McGurn, vice-president of Institutional Shareholder Services Inc.

So where to draw the line? At the very least, every proposal to reprice existing options should be put to a shareholder vote. No less important, repricings for top execs make no sense under any conditions. Stock options are long-term incentives that should not be used to reward a management that fails to produce results.

If anything, Cendant's repricing confirms the need for new accounting treatment for stock options. The Financial Accounting Standards Board is proposing that all repriced options be charged to earnings. The hit would be so considerable at some companies that it would widely discourage repricings. That's a good idea. And Cendant can be the FASB's exhibit A.

Senior writer Byrne covers management issues for BUSINESS WEEK.

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5.13%

5.43%

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AMERICAN
CENTURY

EDITED BY KELLEY HOLLAND

AMR DROPS SOME CARGO

ONLY FIVE YEARS AGO, WHEN airlines were bleeding red ink, American Airlines parent AMR envisioned a day when it might be out of the airline business. How times have changed. Under new Chief Executive Donald Carty, who took the top job in May, a profitable AMR is selling three nonairline businesses "to better focus on its core airline and related technology units." Carty says he expects to have deals by yearend at "a good price." The three businesses, with annual revenues of about \$451 million and operating profits of \$40 million, offer such services as passenger and cargo handling and telemarketing. Carty says the

units are "nonstrategic." But he says AMR has no immediate plans to change its 82% ownership in the Sabre computer-reservations unit.

GETTING STUBBED OUT IN RUSSIA

RUSSIA IS NOT EXACTLY smoking for RJR Nabisco. Economic upheaval there will damage the tobacco giant's third-quarter earnings, the company said Sept. 29. Earlier in September, RJR suspended operations for two weeks at its St. Petersburg plant because of weak sales. RJR's top cigarette in Russia—Peter I, named after the Russian czar—lags two brands from industry leader Philip Morris. The good news: Despite Russia, RJR will be profitable for the third quarter, after being in the red for the first half of 1998.

MICROSOFT TAKES THE BROWSER LEAD

ONE YEAR AGO, MICROSOFT Chairman Bill Gates said his Web browser would overtake Netscape Communications' market-leading product within a year. He nailed it. According to International Data Corp., Microsoft's market share in the first half of this year rose to 43.8%—compared with 41.5% for Netscape. Netscape still holds strong leads in business markets. "The home market is where Microsoft's illegal bundling tactics have made the most impact," says Netscape Senior Vice-President Bob Lisbonne. A Microsoft spokesman says consumers are simply choosing a superior product.

HARD TO WATCH THIS MGM STORY

METRO-GOLDWYN-MAYER'S recent box-office flop, *Dis-*

HEADLINER: ROBERT HAAS

NEW TURBULENCE IN THE JEAN POOL

Robert Haas's ongoing efforts to get Levi Strauss back on track apparently haven't paid off. On Sept. 28, the San Francisco-based jeans giant said that it would shut down two plants in Texas, resulting in a loss of nearly 1,000 jobs. A day later, Levi's announced cuts of almost 1,500 jobs with the shuttering of four factories in Belgium and France—a painful step for Haas, the chairman and CEO who has long espoused progressive, employee-friendly policies. Levi's says the moves were sparked by sluggish demand for its jeans.



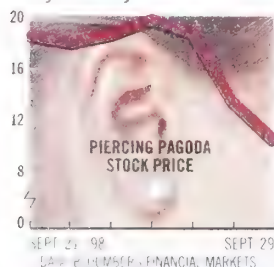
Analysts say the slowdown can be blamed on a combination of increased competition, economic turmoil, and Levi's inability to keep up with fashion trends. What's more, they say the \$7 billion jeans maker has allowed competitors such as Gap, J. C. Penney, and Sears to steal away the most crucial buyers—teens. "Levi's is an item of utility," says retail analyst Kurt Barnard. "Today's kids want more than that." Levi's latest moves, analysts say, will do little to help the company regain its former dominance.

By Linda Himmelstein

CLOSING BELL

PUNCTURED

On Sept. 28, Piercing Pagoda's stock plunged 27% before trading was halted, and the company, an operator of jewelry and ear-piercing kiosks in malls, said quarterly results would be lower than expected. Piercing President John Eureyecko says he doesn't know what triggered the drop. But it's clear what poked holes in Piercing's results: lower sales and higher costs from the acquisition of 107 jewelry kiosks. Piercing plans to close up to 30 of the new locations by spring. "It's a onetime glitch," Eureyecko says.



turbing Behavior, could be an apt title for its own operations. The studio hasn't turned a profit in a decade. And on Sept. 29, it projected a "significant operating loss" for the quarter ended Sept. 30. The latest problems? Writedowns of \$20 million from *Disturbing Behavior* and another flick, *Music From Another Room*, and \$13 million on severance packages. But hope springs eternal: Billionaire Kirk Kerkorian, whose Tracinda owns 90% of MGM, intends to increase his investment as part of a planned \$500 million rights issue.

NEW MATH FOR COLLEGE LOANS

COLLEGE JUST GOT CHEAPER. The Senate on Sept. 29 approved a five-year extension of higher education funding that includes a reduction—from 8.23% to

7.46%—in the interest rate on student loans. The House has already passed it, and President Clinton is expected to sign the measure. To get the rate on existing loans, students have to apply before Jan. 31. The government is also paying an additional 0.5% subsidy to banks that make many of the loans. Lenders had complained that the new college loan formulas would have cut into their profits too deeply.

ET CETERA...

- MCI Worldcom will take \$3.1 billion write-off from its deal, half what it hoped.
- Healthsouth warned that third-quarter earnings will be hurt by pricing pressure.
- AT&T and IBM won \$1.8 billion in networking contracts from Banc One.
- Bank America and NationsBank complete their merger.

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DITED BY OWEN ULLMANN

YES, MONICAGATE WILL MATTER AT THE POLLS

A few weeks back, Democrats had visions of a bloodbath on Nov. 3: Vengeful voters would punish the party's congressional candidates for Bill Clinton's sins. But if the Dems seem a little less despondent now, it's because they're getting that they can minimize their losses by turning all that voter anger back against the Republican impeachment gang. Why the mood swing? Democrats have seized on polls that show the public strongly rejects the way GOP Hill leaders and Independent Counsel Kenneth W. Starr have handled Monicagate. A Sept. 22 survey by nonpartisan Zogby International found that 65% were dissatisfied with the GOP response to the scandal. And according to a new CNN/Time poll, independents believe by a 2-to-1 margin that the GOP has been too partisan.

That may not translate into a broad anti-Republican backlash. But in some cases, the GOP has reason to worry. In New York, where Representative Charles E. Schumer is trying to unseat Republican Senator Alfonse M. D'Amato. New York has always been a liberal bastion, and House Speaker Newt Gingrich (R-Ga.) a political pariah to most Empire State voters.

IRE SPOT. D'Amato is particularly vulnerable to charges of overkill: After he launched caustic attacks on the Clintons while chairing Whitewater hearings in 1995-96, his approval plummeted. Despite an assiduous campaign to woo me-state voters, D'Amato is still looking shaky, and havingillary Rodham Clinton lambaste him as a "Jesse Helms ne" isn't helping. A Sept. 16-22 Quinnipiac College poll showed Schumer's narrow lead growing among likely voters. Even in less friendly territory for Clinton, a GOP attempt to make the scandal an issue may be backfiring. In an Alabama House race, Republican challenger Gil Aust blitzed the air-

waves with commercials calling for Clinton's resignation. But Aust still trails incumbent Democrat Bud Cramer by more than 3 to 1. According to a Sept. 17-18 Southern Opinion Research poll, only 13% of voters say the ads made them more likely to support Aust, while 30% said they were less likely to back the Republican. In South Carolina, Republican Governor David Beasley has been on the defensive ever since he aired TV ads morphing his opponent, Jim Hodges, into Clinton. At issue: Beasley's own truthfulness and personal morals.

Republicans say the Democrats are dreaming if they think a few isolated instances point to a Democratic bounce-back in November. Despite the efforts of unions, liberal groups, and minority activists, the Clinton scandal could still make many party stalwarts no-shows on Election Day. What's more, Republicans have a commanding fund-raising advantage for an 11th-hour media barrage. And with the economy still growing, 1998 is shaping up as a strong year for incumbents from both parties. "Add to that the current 'unpleasantness,' and you have a daunting task" for Democrats, concedes one Administration official.

Gleeful Republicans couldn't agree more. Their core conservative voters are livid over the President's behavior, and that will motivate them to show up at the polls. The Sept. 23-24 CNN/Time poll found that registered voters preferred Democratic congressional candidates over Republicans 47% to 38%. But among likely voters, the GOP held a 49% to 45% edge.

With barely a month to go, one White House tack is to portray Hill Republicans as a lynch mob led by a rope-toting Gingrich. If it succeeds, the Dems could turn a possible electoral disaster into something a bit less painful—a more traditional midterm drubbing for the party in power.

By Richard S. Dunham, with Amy Borrus



SCHUMER AND D'AMATO: Horse race?

CAPITAL WRAPUP

FAST-TRACK BACKLASH?

A House Republican gambit to embarrass President Clinton by forcing a defeat of fast-track trade legislation may cost GOP free traders a key Democratic soulmate. Representative Robert T. Matsui (D-Calif.) threatening to give up his post as ranking minority member of the House Ways & Means trade subcommittee because he's so angry that the GOP demanded a fast-track vote on Sept. 25 even though it was certain to lose. It did: 253 to 180. But the

Republicans achieved their goal of handing Clinton and protrade Democrats a setback less than six weeks before Election Day.

Matsui, a 10-term veteran, helped get Clinton to back most-favored-nation trade status for China during the President's first term. If Matsui bails out, he won't be replaced by another free trader. Likely successors: Representatives William J. Coyne (D-Pa.) or Sander M. Levin (D-Mich.), both from heavily union districts. Panel Chairman Philip M. Crane (R-Ill.) hopes to persuade Matsui to stay.

SOUTHERN STRATEGY SHAMBLES

► California's decision to move up its 2000 Presidential primary to Mar. 7—the week after New Hampshire's balloting—could be a setback for GOP social conservatives. They had hoped to generate post-New Hampshire momentum for an anointed standard-bearer heading into the mid-March Super Tuesday primaries in the South—true-believer territory. But California's socially libertarian voters aren't likely to unite behind a Pat Robertson-type firebrand.

DEALMAKERS

HIGH TIMES FOR A FORMER MILKEN MAN

Gary Winnick scored big with Global Crossing's IPO

President Clinton would be there. So would Sylvester Stallone and Jeff Goldblum. But financier Gary Winnick, in search of his first billion-dollar investment, decided to skip the mid-August Democratic fund-raising bash at the home of Hollywood mogul Jeffrey Katzenberg. Instead, he headed for his own gathering of potential investors in New York, sending his 20-year-old son in his place.

The deal ended up being worth the trip. Even as Wall Street was caught up in market jitters, Winnick's \$399 million initial public offering for Global Crossing Ltd. was oversold at \$19 per share. That currently values the 50-year-old Winnick's 24% stake in the company, which owns and operates a digital-telecommunications cable under the Atlantic, at \$1.2 billion. Global Crossing has grand plans to undercut existing carriers worldwide with phone and data offerings. "It was a home run for me," says Winnick from his Beverly Hills office.

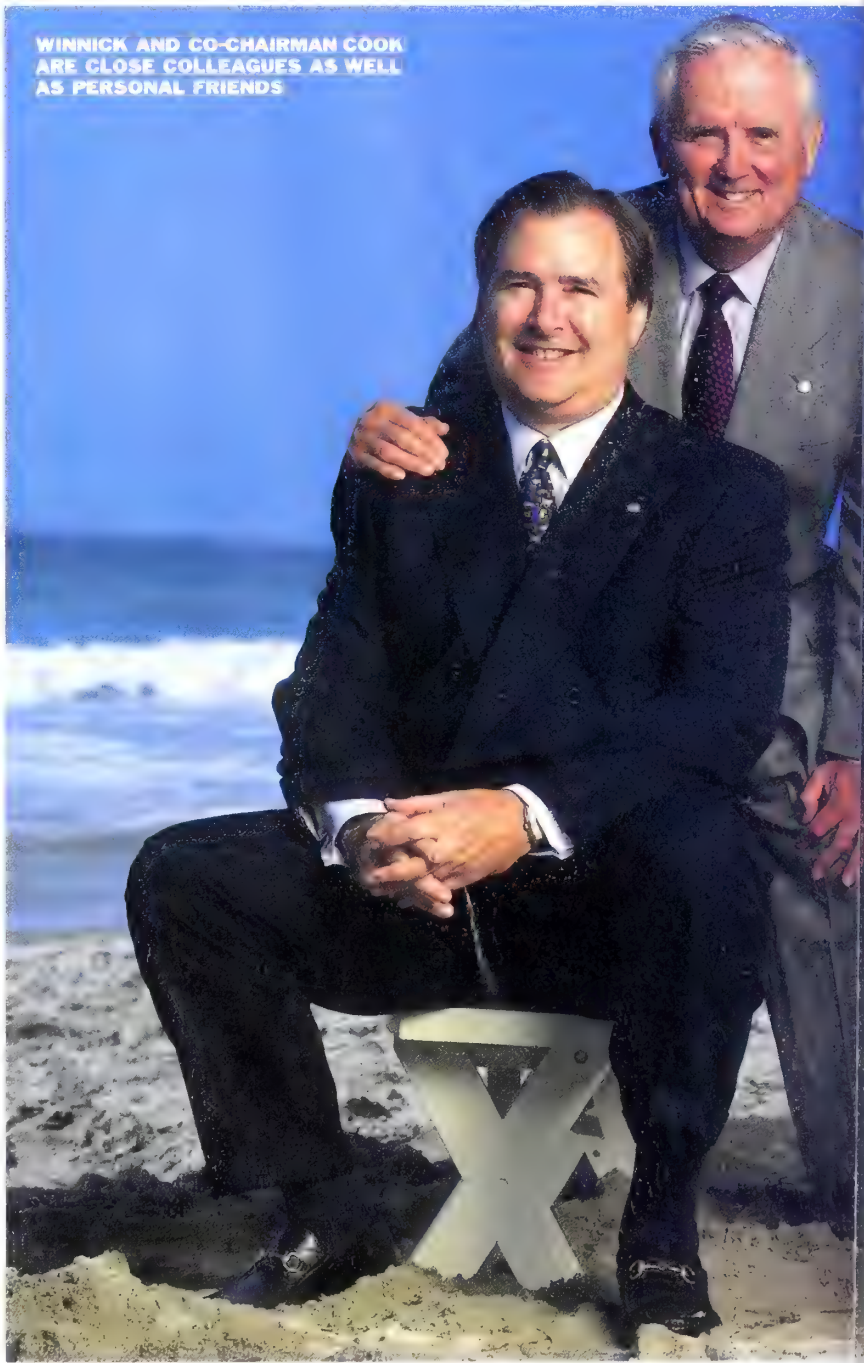
LOW PROFILE. The deal was also a coming-out party for one of Los Angeles' most private dealmakers. Since 1985, when he left Drexel Burnham Lambert after working for nearly a decade with junk-bond guru Michael Milken, the one-time furniture salesman has kept a low profile while buying and selling companies in retail, health care, reinsurance, real estate, and entertainment. Now, his deals are getting plenty of attention. In addition to Global Crossing, Winnick and his partners are expected to soon exercise their option to buy a 27% stake in Playa Vista, the long-stalled 1,087-acre Los Angeles housing and retail development where DreamWorks SKG has tentatively agreed to locate its new studio facility. After months of tense negotiations, DreamWorks and Playa Capital, the property's developer, have tentatively agreed to move forward with a 48-acre DreamWorks studio.

Most of the flurry of deals Winnick is pursuing involve Global Crossing, which plans to spend \$2.8 billion to lay four separate underwater fiber-optic cables

that eventually will connect the U.S. to Europe, Asia, and Latin America. Japanese phone company DDI Corp. signed up to use Global's U.S.-Japan undersea cable, and long-term deals have already been signed with Denver-based Qwest Communications International Inc. and Germany's Deutsche Telekom to use the company's U.S.-Europe line. In early October, Global is expected to announce a \$700 million deal to link its undersea lines with more than a dozen major European cities.

Capitalized with more than \$3.5 bil-

WINNICK AND CO-CHAIRMAN COOK ARE CLOSE COLLEAGUES AS WELL AS PERSONAL FRIENDS



on, says Winnick, Global Crossing plans to eventually provide phone and data service to the top 100 cities in the world, which account for 85% of global telecommunications traffic. It's a risky proposition, if only because AT&T and three other major carriers plan to lay a competing cable under the Atlantic, and another consortium is laying another under the Pacific. Still, international phone and data traffic is the fastest-growing segment of the business, and Global figures its deals with local phone operators will protect them down the road. "They've got the advantage of being the first to lay down cables," says Mark Langner, a research associate at

Global is spending \$2.8 billion laying cables beneath the Atlantic and Pacific. The goal: Providing service in the world's top 100 cities

Hambrecht & Quist. "But it is hyper-expensive, and you can't just be a wholesaler to play this game. It makes sense for these guys to build a network."

Winnick's empire-building is a far cry from Drexel, where the Long Island native started out as a bond salesman for Burnham & Co. A large, beefy man who prides himself on being a tough negotiator, Winnick was recruited in 1978 by Milken to move west with the high-yield group. He left seven years later. He was not implicated in the investigation that led to Milken's prison term. Milken was a "brilliant guy," says Winnick. "He was just a little misguided."

Winnick is a charter member of the vast network of former Drexel employees, many of whom are in prominent positions and do deals with each other. Winnick's first deals after Drexel were for a partnership that included Milken and such Milken clients as the Bass Brothers and Richard E. Rainwater. He is close to CIBC Oppenheimer Corp., which arranged the initial \$200 million to begin laying the Atlantic cable in 1997.

Not all of Winnick's deals have worked out well. One of his first, the 1988 purchase of Los Angeles-based RB Furniture Inc., fizzled when the early '90s recession forced it into bankruptcy. Winnick bought the company for \$48.5 million and then sold a 35% stake to a former Drexel client, First Executive Corp., in exchange for \$53.5 million in junk bonds. Winnick, who served as chairman for two years before selling in 1991, says he broke even.

Most of Winnick's time these days is spent on the telecom industry. In 1994, he bought a controlling interest in OpTel Inc., which provides satellite-delivered television services to apartment buildings. He says he made \$100 million on his \$12 million investment when he sold it to Montreal-based Le Group Videotron last year.

Winnick recently began focusing on the use of voice and data lines worldwide, which was fast outpacing wire and satellite capacity to deliver it. A key deal was a contract in March, 1997, with AT&T Submarine Systems, one of the few worldwide companies capable of laying underwater phone lines. To

get the deal, Winnick paid big bonuses to lure several of the unit's senior managers, including its top two executives.

Winnick raised \$75 million in equity, including \$20 million of his own, to launch the project. Among the investors was the Union Labor Life Insurance Co., backed by the AFL-CIO pension fund, which has \$3.2 billion in assets. To get the bank's \$7.5 million investment, says the union's senior vice-president, Michael R. Steed, Winnick promised that much of the construction would be union labor.

CIRCLING THE GLOBE. A big breakthrough came from the Tisch family, which invested in the project's junk bonds and then raised its stake to \$100 million by buying equity. "We like Gary," says James S. Tisch, president of the family-run Loews Corp. "Sure, he's a *spielmeister* like a lot of dealmakers. But he has also put together a great team, and he has a great concept."

That team is headed by Jack M. Scanlon, a former president of Motorola Inc.'s cellular unit. It also includes former Arco Chairman Lodwick M. Cook, who was a member of a GOP fund-raising group with Winnick. As colleagues, Winnick and Cook are unusually close. And despite the disparity in their ages—Cook is 70—they are also close personal friends. Where Winnick tends to the hyper, Cook is a calming influence. Recently returned from China, Cook has been instrumental in opening up new territories.

Global Crossing's biggest coups are the deals with phone companies to use the undersea lines. The company has nearly paid for its first cable, says Winnick, by signing more than \$600 million worth of 25-year contracts to provide capacity to 22 carriers, including Swisscom and GTE Corp. The company is also negotiating with such players as British Telecommunications and AT&T.

For now, Winnick intends to remain chairman of Global Crossing, pursuing a state-of-the-art cable system that he says will one day circle the world. Will he sell out, especially as other phone-company heavyweights gear up to add their own new capacity? "I'm not looking to sell," he says, sitting in front of a blackboard crisscrossed with lines showing Global Crossing's worldwide routes. But if someone decides to beat that valuation, Winnick might just decide to turn his billions from paper into cash.

*By Ronald Grover in
Beverly Hills, Calif.*

GARY WINNICK

65

EDUCATION: BA, economics, from C.W. Post College, 1969

CAREER: Drexel Burnham Lambert (1972-1985); Chairman, Pacific Capital Corp. private investment group (1985-1988); Co-Chairman, Global Crossing Ltd. (1988-1997)

PERSONAL: Lives in Beverly Hills; Wife, Deborah; 2 sons; Board of Directors, International Brotherhood of Bookbinders

OWNINGS:

4% stake in Global Crossing, valued at \$1 billion
1% stake in Ventas Reinsurance, reinsurer valued at \$200 million
1% stake in Playa Vista, real estate project, valued at \$100 million
1% stake in CampusLink, college telecommunications service, value: \$100 million

LODWICK M. COOK

70

EDUCATION: BS, Louisiana State, 1955; Southern Methodist Univ. 1965

CAREER: Atlantic Richfield Co. (1966-1995); Chairman and CEO (1986-1995); Chairman Emeritus (1995-) Co-chairman, Global Crossing Ltd. (1998-)

OWNINGS:

1% stake in Global Crossing Ltd., valued at \$53 million

COMMENTARY

By Paula Dwyer

WALL STREET'S SOFT DOLLARS: ONLY A BAN WILL DO

In almost every industry, a person who accepts payment in return for steering business to a company is deemed to have received a kickback and risks prosecution. Except in the investment-advisory business, where the practice is almost universal and where it costs investors billions of dollars. A recent report by the Securities & Exchange Commission staff found a wide variety of abuses involving legal kickbacks, or what the investment advisory industry calls "soft dollars."

Here's how soft dollars work: A money manager executes a trade and pays a brokerage commission. In many cases, the brokerage commission paid by the money manager is higher than the actual cost of the trade plus a reasonable fee. The spread is soft dollars. The fund manager is supposed to use soft dollars to get research services, such as company reports, news services, or technical charts.

Who pays for the soft dollars? The investors in the fund, who pick up the tab for brokerage commissions. Instead of going to a cut-rate broker, the fund manager patronizes a high-cost firm in order to generate soft-dollar rebates. But if a rebate isn't spent on research—or the research doesn't directly benefit the investors who paid the commission—the higher commission is cash taken out of the investors' pocket.

These relationships are allowed under the 1934 Securities Exchange Act, as long as they are disclosed to investors. But the SEC report found that disclosure is flimsy at best and often nonexistent. The Commission is now considering new rules that would require more complete disclosure and better bookkeeping by both the brokers who refund soft dollars and the investment advisers who receive them. But the focus on cleaning up soft-dollar practices is misplaced. Disclosure is fine, but that's not enough. Congress needs to step in. It's time for the SEC to seek congressional

authority to ban soft dollars outright.

An entire industry of soft-dollar-dependent brokers and research suppliers has grown up around this practice. It's so universal that the money-management industry last year recaptured more than \$1 billion in commissions. Says Craig S. Tyle, general counsel at the mutual fund trade group Investment Company Institute: "My guess is everybody uses soft dollars to some extent. It's hard to be 100% free from it."

Richmond T. Fisher, chief executive of S&P Securities Inc., derives 100% of his business from soft dollars. But Fisher, whose company, like

cution and the portion for research.

The SEC report, though, documents numerous abuses. In an inspection sweep of 280 investment advisers and 75 brokers in the six months ended in April, 1997, 35% of brokers provided, and 28% of advisers received, nonresearch products and services. Soft dollars were used to pay salaries, office rent, telephone services, legal expenses, and entertainment. Virtually all advisers who used their refunds for something other than research failed to adequately disclose it.

CLEAN SWEEP? Even among the advisers who stayed within SEC guidelines—and spent their rebates on research-related products—half poorly disclosed their soft-dollar expenses.

Says Lori A. Richards, director of the SEC's Office of Compliance, Inspections & Examination, about 20 firms "engaged in egregious fraud" and have been referred to the Enforcement Div. for possible legal action. While Richards will not name any of the companies, she says none were mutual funds.

While the SEC is expected to move quickly to clean up the practice, the agency is partly to blame, says former SEC chief litigator Richard A. Levan, for failing to enforce its own rules. "The less scrutiny, the more opportunity to manipulate the system," says Levan.

There are many ways to make the system more transparent. Wall Street firms could start by unbundling the cost of services that commission fees are supposed to cover. Money managers could be more selective and pay only for those products and services they need to improve their fund's bottom line. And investors could start demanding more information on the hidden costs behind soft-dollar rebating. But only Congress can give the industry a clean sweep overnight by banning soft dollars altogether.

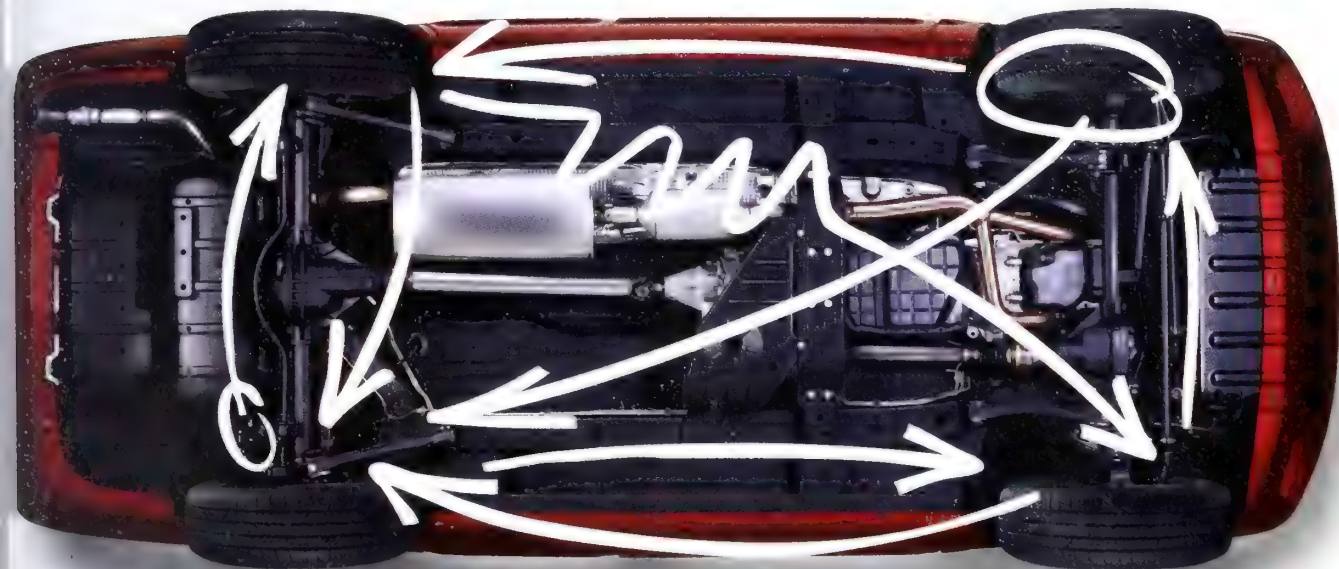
Paula Dwyer covers securities industry issues from Washington.



BUSINESS WEEK, is a unit of the McGraw-Hill Companies, says there's nothing wrong with that. When used properly to acquire research, he argues, soft dollars benefit investors. "Educated investment advice comes from research," he says.

Indeed, most money managers strongly defend soft dollars as their lifeblood. Typically, \$1 of credits accrues for every \$1.60 worth of brokerage commissions paid. Tyle, however, argues that it would be difficult to separate out the portion of commissions that goes for exe-

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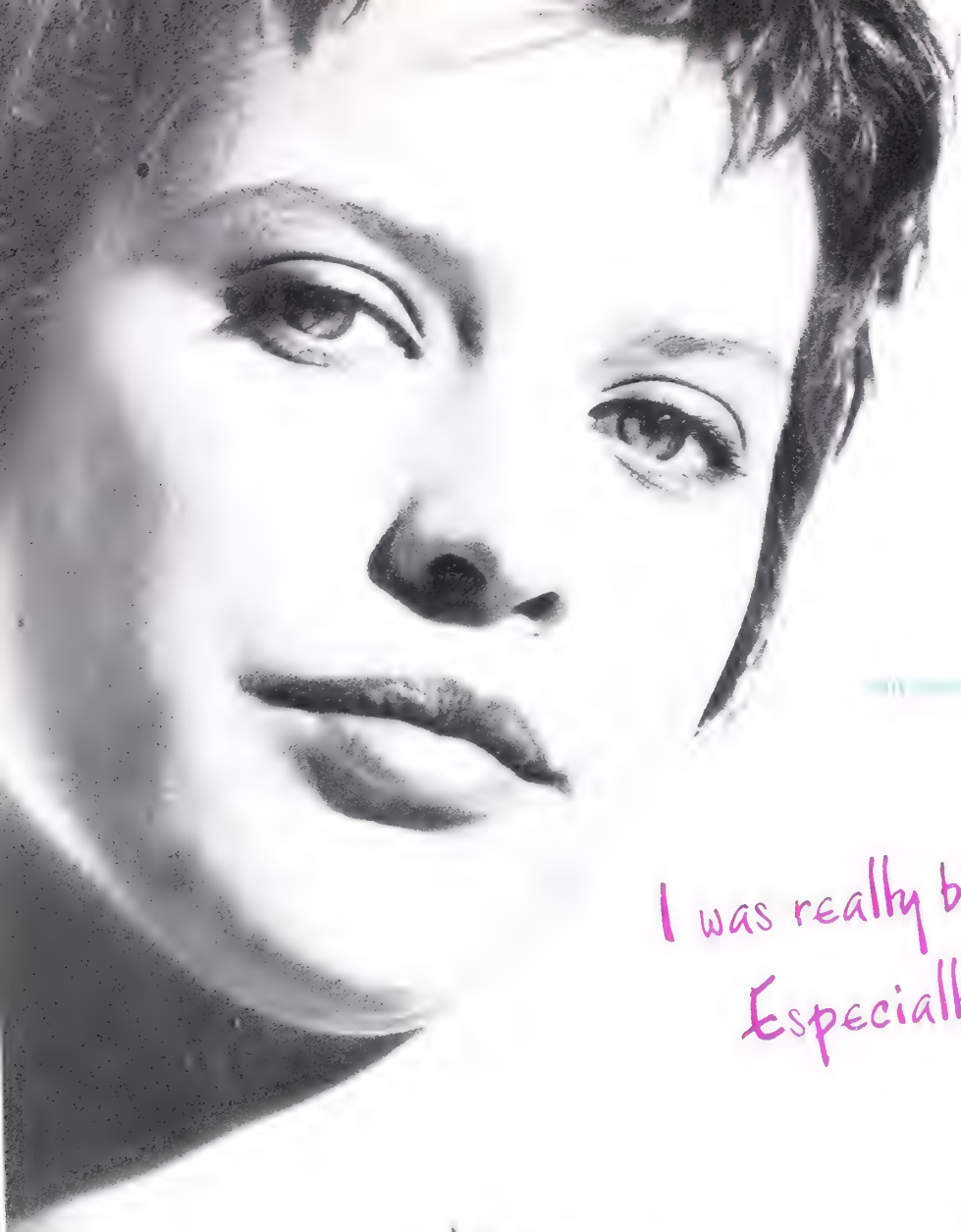
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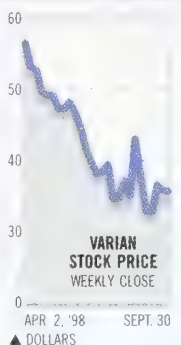
Let's make things better.

BY GENE G. MARCIAL

IS VARIAN FAR MORE THAN ITS PARTS?

When Varian Associates (VAR) announced on Aug. 21 that it would spin off two of its three businesses, its stock popped up nearly 7 points, to 43 a share. But much of that gain melted in a couple of weeks when investors sensed that profits from its semiconductor-equipment business would come under pressure. Indeed, on Sept. 25, Varian warned that fiscal fourth-quarter earnings would be disappointing.

CLIPPED BY CHIP-EQUIPMENT WOES



DATA: BLOOMBERG FINANCIAL MARKETS

No matter, says Joseph Cornell, president of Spin-Off Advisors, a Chicago firm that specializes in finding inefficiently priced stocks involved in spin-offs. Varian's stock, now at 35¢, is below its sum-of-the-parts value, argues Cornell. "The market is placing a value of \$1.1 billion on the stock; we believe Varian's three separate businesses will garner a higher market value as separate companies—a total of about \$1.5 billion, or \$50 a share," Cornell says. Varian has three core businesses: health-care systems, analytical instruments, and semiconductor equipment.

Varian will spin off to shareholders its health-care and instruments operations. The health-care unit, which makes X-ray tubes and radiation machines for cancer treatment, should have 1999 revenues of \$570 million and aftertax profits of \$40 million, estimates Cornell. This business, he figures, is worth about \$22 a share, based on a price-earnings multiple of 17, vs. an industry p-e of 20. The instruments unit, which makes lab and analytical tools for chemical analyses, should have sales of \$615 million and earnings of \$28 million. At one times sales, it is worth \$20 a share, he estimates.

Varian's semiconductor unit makes and services ion-implantation systems—a key step in producing chips. Most of the major chipmakers use its equipment. Because of weak sales, Cornell

expects that the unit's 1999 sales will fall to \$275 million, from 1998's estimated \$424 million. Profits, he adds, should drop to \$5 million, from \$10 million. He values the unit at 90% of sales, or \$8 a share.

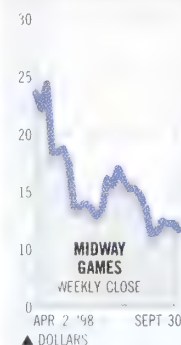
THE BETS ARE BIG INSIDE THE MIDWAY

Insiders at Midway Games (MWY), maker of video games for coin-operated machines and home players such as Nintendo, Sony, and Sega systems, are placing big bets on their own stock. With Midway shares at 12—down from last year's high of 26, insiders, including Chairman and CEO Neil Nicastro and Executive Vice-President and Chief Financial Officer Harold Bach Jr., have been big buyers. Do they know something that outsiders don't?

"All we can say is the stock at these levels is a bargain," says Nicastro, who bought 100,000 shares in May and June at an average price of 13¢ apiece and another 20,000 shares in August, when the stock's price had slumped to 9¢. So far, he has accumulated 433,000 shares—or 3% of the 37 million shares outstanding.

Midway's largest investor is Viacom Chairman and CEO Sumner Redstone, who has a 25% stake. Redstone got the shares when WMS Industries—of which he owns 26%—spun off to shareholders in 1997 its 87% Midway interest.

INSIDERS BUY ON THE DIPS



DATA: BLOOMBERG FINANCIAL MARKETS

Nicastro says he has no idea if Redstone will buy more shares.

Midway itself is buying back shares: After repurchasing 1 million in August, it recently authorized buying another 1 million.

Analyst Robert Peterson of Piper Jaffray is also bullish on the stock: His 12-month target is 20, based on his 1999 profit estimate of \$1.40 a share. With a p-e of 9, Midway is very attractive, vs. a p-e of 15 for its peers, he notes. Another plus: Midway's latest game, NFL Blitz, is expected to be a hit this Christmas, along with such mainstays as Mortal Kombat and Space Invaders.

BIO-TECH GENERAL ISN'T STUNTED YET

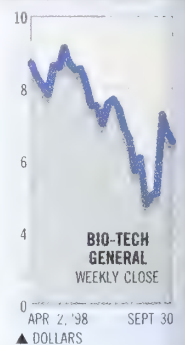
Bio-Technology General (BTGC) is still recovering from the one-two punch the Food & Drug Administration delivered early this year, knocking it from its 1998 high of 10 to 6¢. But not everyone is scared. Michael Petusky of Branch Cabell, a Richmond (Va.) investment firm, calls the stock "significantly undervalued given its growth potential." It trades at 9 times his 1999 profit estimate of 46¢ a share. His target: 11¢. Bio-Technology, among the few profitable biotech, is expected to have revenues of \$80 million this year, up from 1997's \$65.3 million.

In January, the FDA deemed a "not approvable" AndroTab SL, a delivery system for testosterone, until Bio-Technology could provide more data. In February, the FDA asked for more data on OxSODrol, a product to prevent a lung disease in premature newborns.

But Merrill Lynch analyst Paul Woodhouse in London isn't troubled by the setback. He calls the stock cheap and says his '98 and '99 estimates and his 5-year objective of 25% yearly growth "remain intact." He notes the huge success in Japan of Bio-Tropin, a growth-hormone product. Bio-Technology, which has five FDA-approved products sold globally, has made an agreement with Japan's Sumitomo to sell Bio-Tropin in Japan. The deal could push Bio-Technology's growth-hormone annual sales in Japan from \$10 million to \$30 million by 2000, says Allan Roness of JW Genesis Capital Markets in Boca Raton, Fla.

Another kicker: The company plans shortly to start marketing its FDA-approved BioLon, used as a lubricant in such ophthalmic procedures as cataract removals. BioLon could produce sales of \$15 million in 1999, says Bio-Technology CEO Sim Fass.

A GROWTH HORMONE BOOST?



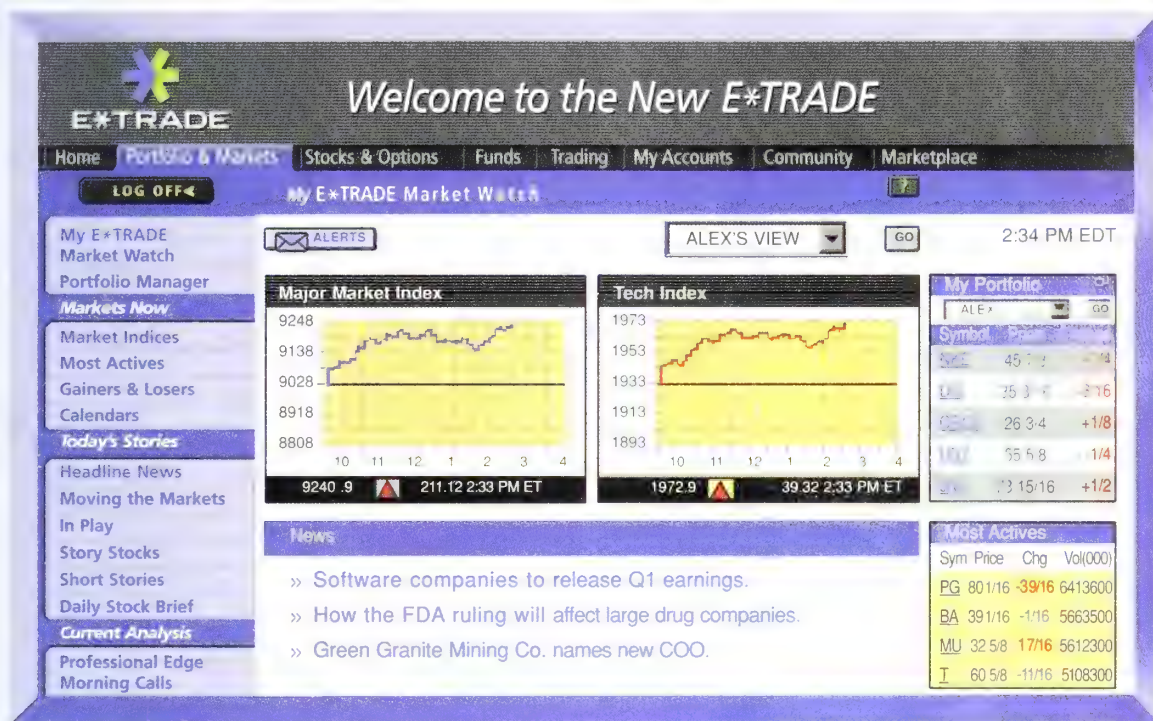
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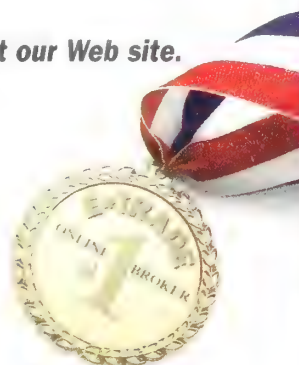
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Can the founder of Netscape and Silicon Graphics ring up another blockbuster?

After Silicon Valley entrepreneur James Clark built a new swimming pool behind his home in Atherton, Calif., he discovered to his chagrin that the backyard neighbors had an eagle-eye view into the pool from their breakfast nook. The obvious solution was to put up a taller fence, but that was against zoning rules. Clark's answer was to haul in dirt to build a hill in his backyard—thus elevating the fence. "That's the way he thinks," says longtime friend Robert Burgess, the CEO of Macromedia Inc. "The fence can only be this high? Then raise the land. Change the rules."

Clark has been changing—and breaking—the rules ever since he can remember. Today, he's best known for founding Internet pioneer Netscape Communications Corp. Before that, he launched Silicon Graphics Inc., whose high-powered computers transformed the way everything from suspension bridges to jet aircraft get designed. "He's a rebel who has a cause," says Larry Sonsini, a Silicon Valley attorney who has represented all of Clark's four startup companies to date.

20/20 FORESIGHT. Clark's cause is proving himself. Not just once, but over and over again. As a teen, he was ashamed of his parents' divorce and his own failure to graduate from high school—he was a dropout at 16. But by his 20s, Clark was striving to put distance between himself and his troubled youth. He was working full-time as a computer programmer to support a young family while studying to get three degrees, including a PhD in computer science. Later, he proved his scientific ideas in the field of computer graphics to fellow scholars by making them come alive at SGI, Clark's first venture. Then, Netscape proved that SGI was no fluke.

Clark's genius is his ability to see emerging trends, then create a company and assemble a team to exploit them. "Entrepreneurs believe they can create the future," says Marc Andreessen, a co-founder and executive vice-president at Netscape. "And when you're Jim Clark, you're right." Now, Healtheon Corp., which he co-founded in 1996 to provide online medical data to physicians and hospitals, is expected to go public next month. If it braves the tumultuous stock



ENTREPRENEURS

JIM CLARK IS OFF AND RUNNING AGAIN

market, Clark will have accomplished what no one else has yet been able to do: start three technology companies with market values of more than \$1 billion each. "Then nobody will be able to say it was just luck," says Clark.

Given the shaky financial markets, a little luck couldn't hurt. Analysts agree that Healtheon is well positioned to revolutionize the health-care business by streamlining the way patient information is handled, but they say it has yet to prove itself. The Santa Clara (Calif.) company lost \$12.2 million in the second quarter, on revenues of just \$11 million. Janice Young, an analyst with the Gartner Group, says Healtheon has solid management and a potent technology.

JAMES CLARK

BORN 1944,
Plainview, Tex.

EDUCATION BS
1970, MS 1971,
Louisiana State
University; PhD
1974, computer
science, University of Utah.

MOST SURREAL EXPERIENCE

Witnessing an atomic-bomb test at Christmas Island in the South Pacific while in the Navy.

FIRST BUSINESS A "loan shark" operation while in the Navy, making loans at 40% interest to tide over fellow sailors until payday.

CURRENT JOBS Chairman of Netscape Communications and of Healtheon, a health-care communications venture expected to soon go public.

CLARK'S CREDO "You've got to be bold—but be fearful, too. If you go into a business thinking you'll show the world, often the world will show you."

TOYS BMW motorcycle, stunt plane, 7-seat Boeing helicopter, and a new, \$30 million, 155-foot sailboat packed with 20 computers.

HOME LIFE Splits free time between West Palm Beach, Fla., and Atherton, Calif. Wife, Nancy, a journalist, is his third. Two grown children from a previous marriage.



but she believes the health-care industry will be slow to adopt Web-based services. "We know the opportunity is coming. The question is when," she says.

Clark doesn't exactly need the money. He's already worth about \$500 million. But a successful Healtheon IPO would put him firmly in the pantheon of high-tech demigods—one notch below Apple Computer's Steve Jobs, Intel's Andy Grove and Microsoft's Bill Gates. "Twenty years from now, Jim Clark will be one of the names in the Valley that people remember," predicts Forest

Baskett, the chief technology officer at SGI and a former academic colleague of Clark's at Stanford.

He is not, however, likely to ever be remembered as a saint. The imposing 6-foot, 3-inch Texan often blows his top when he gets angry. During Netscape CEO James L. Barksdale's first week on the job, for instance, "he just started screaming and hollering," recalls Barksdale, who told Clark he wouldn't tolerate that kind of behavior. "That was the last time it ever happened," adds Barksdale.

THE YOUNG TEXAN:
Head held high

Clark has long since come to understand his weaknesses. When he was chairman of SGI, he fought with then-CEO Ed McCracken, forcing key employees to take sides. But though he left Netscape for nine months, Clark figured out that managing isn't his forte. He now leaves his handpicked CEOs to run the companies as they see fit. Barksdale says his employment contract allows him to ask Clark to step down as chairman if he interferes. "I never had to ask," says Barksdale. Adds Clark: "If you're not managing the company, you'd better not be in there telling the general which hill to take." Instead, Clark serves as an adviser to his managers and their engineering teams after his companies get off the ground.

The hands-off approach leaves Clark plenty of time to focus on his next big project, one that he hopes will eventually grow into a real business. He's building a 155-foot sailboat, Hyperion, which is scheduled to be launched in November from the Royal Huisman Shipyard in the Netherlands. The \$30 million boat is packed with electronics gear, 20 computers, and an elaborate

"I'M NEVER
CONTENT": CLARK
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control system Clark has dreamed up.

The boat project demonstrates just how much Clark's life has changed since his hardscrabble Texas panhandle childhood. He grew up in the 1950s and early '60s in Plainview, Tex., home of country singer and sausage king Jimmy Dean. As a youth, Clark was so poor he couldn't afford to buy a band instrument, so he played the school's tuba. Clark's mother worked in a doctor's office. His father did odd jobs—but suffered a drinking problem and a violent temper, say Clark and other family members. After his parents divorced in 1958, when Clark was 14, his mother supported him and his brother and sister on \$225 a month. "We lived quite meagerly, but our heads were held high," says his mother, Hazelle McClure, now 75, who still lives in Plainview, in a house bought with Netscape stock her son gave her. His father now lives in a Texas convalescent home but was not able to be interviewed for this story.

Clark's head may have been held high, but he also had a chip on his shoulder. He got booted out of school once for setting off a smoke bomb on the band bus. The highlight of a typical week, recalls childhood pal John Speck,

now a Plainview farmer, was "snitching some beer" and drag-racing down Fifth Street on Saturday night, then swinging around the Trio Rebel drive-in and listening to Buddy Holly on the radio. Lamont Veatch, Clark's former principal, remembers that Clark got in trouble to escape the tedium of classes. "He'd just come in and bend over and wait for me to pop him on the tail," says Veatch. When an English teacher upbraided him for failing to read *The Rime of the Ancient Mariner* and Clark told her to "go to hell," he was suspended and never returned.

GEOMETRY ENGINE. Ambition finally came to Clark during a stint in the Navy, when he got his high school equivalency diploma and started college. Physics captivated him first. Then computer science. At the University of Utah, he saw his first high-performance graphics computer. And by the time he landed as an assistant professor at the University of California at Santa Cruz in 1974, he was thinking of bringing 3-D computing to engineers.

After he got a job as an associate professor at Stanford University, Clark got a piece of a Defense Dept. grant and started working on the ideas that ul-

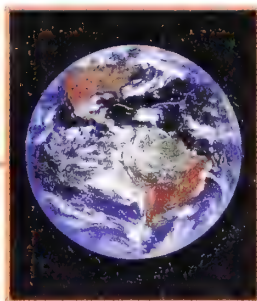
timately found expression in SGI. His goal was to design a special-purpose computational system that would allow real-time, 3-D graphics to be created on a single microchip. His invention: the so-called Geometry Engine, which would later allow engineers to model their designs on relatively inexpensive computers, saving months of work and tens of thousands of dollars.

That's when Clark's life became a sprint. He had watched with envy as other Stanford scholars left to start Silicon Graphics. His friend and art dealer, found Clark convincing that she lent him \$25,000 to get SGI started in 1982. Unlike many other scientist-entrepreneurs, Clark did not limit himself to technology matters as SGI matured. Colleagues say he was the first to push for making stand-alone workstations, rather than terminals that

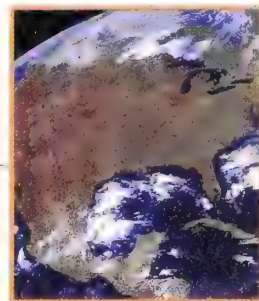
JIM CLARK'S KNACK FOR STARTUP



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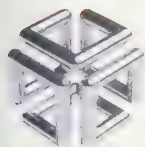
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SILICON GRAPHICS

Founded in 1982. Its powerful graphics computers are a hit with engineers and Hollywood effects studios. Faces fierce competition from makers.



NETSCAPE COMMUNICATIONS

Popularized the Internet with its 1994 browser. Prospects fading since Microsoft started giving away a similar browser. Now trying to reinvent itself as a corporate software provider.



HEALTHEON

Founded in 1996, it provides online medical data to physicians, HMOs and, ultimately, patients. Public offering expected soon, despite continuing losses and recent market turmoil.

Jermoluk. But Clark rethought Jermoluk's idea and concluded he was right. And SGI quickly changed its chip strategy. "His first reaction is to be emotional," says Jermoluk, who later went on to be SGI's president. "But, faced with the facts, he makes the right decision."

In spite of all that, Clark looks back on his years at

being leashed to mainframe computers. Later, he urged the company to bring prices down so it wouldn't be overcome by cheaper PCs.

Just as important, he served as the company's top cheerleader, heaping praise on rank-and-file engineers at every turn. Pavan Nigam, a former SGI engineering manager and now a co-founder of Healtheon, recalls a high-profile event for SGI's Interactive TV joint venture with Time Warner Inc. and AT&T. Most of the execs talked about their visions of the digital future,

but "Jim talked about what a great feat the engineers had pulled off," says Nigam. "He's become larger than life—he's a mythical figure" for engineers.

EMOTIONAL REACTIONS. Clark also learned important lessons about listening to others. When Tom Jermoluk, now CEO of @Home Networks Corp., arrived at SGI, he called for a fundamental shift in the way the company put graphics chips in its workstations. Clark threw a briefing book at him. "He said, 'You want to be the guy who takes the silicon out of Silicon Graphics!'" recalls

SGI with regret. Though he remained chairman of SGI from its inception in 1982 until he left in 1994, Clark's style eventually proved too freewheeling and his influence waned. During Clark's last few years, he fell out with CEO Ed McCracken. He got the message that it was time to move on. "I felt that someone had taken away one of the passions of my life," Clark says. But he also concedes he learned never again to crowd a CEO of one of his companies. Says McCracken: "He needed to have a bigger cut in the action—both fi-

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nancially and in terms of influence."

Not long after leaving, Clark achieved both goals with Netscape. Back in early 1994, the tech world was fixated on the promise of interactive TV. But Clark soon moved in another direction. Eager for a new project, he E-mailed Marc Andreessen, the 22-year-old phenom who had helped create the Mosaic Web browser while a student at the University of Illinois.

WEB FEAT. At first, Clark intended to pick Andreessen's brain and assemble an engineering team to start a new interactive-TV related business. But his talks with Andreessen convinced Clark that the Internet was the way to go. "Everybody said you can't make money on the Internet, but I said there are a lot of people out there using it, and I think you can," recalls Clark. His enthusiasm won over Andreessen. While he quickly moved to round up Mosaic's core engineering team, Clark recruited Barksdale.

Even before Netscape went public, in the summer of 1995, Clark was already looking for his next startup. His focus: industries that could be transformed by Web communications. He settled on health care because of his own



HEALTHEON'S NIGAM: "Jim's a mythical figure"

frustrations filling out forms and waiting in doctors' offices. Why not create a system that would slash red tape and create a central depository for a person's records and billing information? Clark recruited Pavan Nigam from SGI.

When Clark called Pavan to talk about Healtheon, "there was there in 30 minutes," says Nigam. "It was a Jim project." Now Nigam is creating a software and service platform for the entire health-care business.

Healtheon's first year, however, was rocky. It took months to focus on a market—corporate human resources departments. And it was a year before Clark hired a permanent CEO, Mike Long, who had successfully piloted financial software maker Continuum for 19 years. Then Clark gave Long the O.K. to shift focus to physicians' organizations, and that yielded a handful of major clients, including physicians' management firm Brown & Tolan.

At Healtheon, Chairman Clark seems to have mastered the balancing act of playing a key role while avoiding an power struggle. CEO Long says he encourages Clark to come in and talk to him and the engineers—to challenge

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their thinking. Clark keeps pressing the company to work on health-care services for individuals, for example. "As a result," says Long, "we have a team working on it, even though it might be several years away."

This is Clark's new approach to life—something he calls his "orangutan" philosophy. So long as it pleases him, he hangs on to each of his projects like an ape grasps a jungle vine. But if something becomes troublesome, he reaches out for the next handhold and goes on to the last one. At the moment, when he's not helping out at Healtheon, Clark is putting in long days programming software for the boat at his west company, Seascope Communications Inc. in a one-room office above a nearby Craig Weight Loss Center in Menlo Park, Calif.

Clark rarely stops working, even when he's supposed to be relaxing. And he brings the same intensity to his boat project as he does to his startups. "I'm never content," jokes Clark, describing himself as "a maniac who has his mania partly under control."

The underlying technology he's creating for his boat may ultimately spawn new business, he hopes, applied to control systems for homes, commercial buildings, and industrial processes. As for Netscape and the browser mar-

LESSONS LEARNED Clark's angry outbursts were infamous during his years at Silicon Graphics and Netscape. But at Healtheon, he plays a key role while avoiding friction

ket, that would put him in conflict with Microsoft again—since it, too, is designing such systems. But that doesn't deter Clark, who views Gates as a "dictator" bent on controlling the computer industry. "Being anti-Microsoft is an important part of my life," he says. "In a curious way, it drives me."

RENEGADE ROLE. Such comments make Clark popular in Silicon Valley, though he prefers a relatively low profile. He and his wife, journalist Nancy Rutter, enjoy giving small dinner parties, with \$1,000 bottles of Burgundy, or treating friends to join them on sailing vacations. He pals around with billionaire Bill Koch, who also grew up on the Great Plains. Koch, chairman of Oxbow Corp., a power company, says Clark has been a friend during years of family legal battles. "Jim sticks up for me, though it might be to his social detriment," jokes Koch.

Clark, though, isn't one to worry

about his social standing. He's been known to eat at the Ring-A-Ding Diner in nearby Hollister, Calif., where he orders the chili-burger special—an open-face hamburger and fries smothered in chili, which reminds him of Texas. In fact, the recent 100-degree days in rural Hollister haven't been all that different from a late-summer afternoon in Clark's hometown of Plainview. Like Hollister, Plainview was flat and brown.

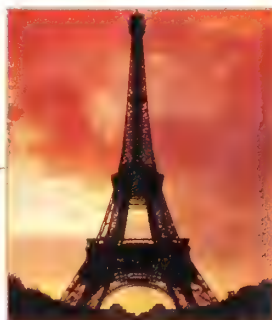
But as he travels back over to the Valley, it's clear just how far Clark has come from his Plainview days. With Netscape and SGI already having changed the face of the computer industry and another potentially transforming company about to launch an IPO, Clark is relishing his role and his life as a computer-industry renegade—Silicon Valley's antidote to Bill Gates.

By Steve Hamm
in Mountain View, Calif.

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CEREAL-BOX KILLERS ARE ON THE LOOSE

New packaging and products are ripping into Kellogg's share

The contrast speaks as loudly as Tony the Tiger's roar. In the last month, the Kellogg Co.—the nation's largest cereal maker—has announced it's considering a big layoff at its headquarters in Battle Creek, Mich., and the chiefs of both its North American and European divisions have quit. Earnings have missed their target in each of the last two quarters, and the stock, at 34, is down more than 30% this year.

Meanwhile, at the Quaker Oats Co.—a relatively small fourth player in the industry—cereal volumes have increased every quarter for the past two years. Market share is up two percentage points in the last two years, and the stock is trading near its all-time high.

So what's Quaker's secret? It's in the

bag—the cereal bag, that is. For the past three years, Quaker has been rolling out a line of bagged cereals that are cheaper versions of its rivals' national brands. By skimping on packaging and marketing costs, Quaker can sell bagged products for about \$1 less than boxed counterparts. And Quaker is not alone. Malt-O-Meal Inc., a smaller Minnesota company that has long produced boxed knockoffs of the national brands, also now offers its cereal in bags. Since 1995, bagged cereals have skyrocketed from virtually nothing to account for 8% of all cereal packages sold. "The taste is similar, and it's probably a dollar or two less," said Jim Buchner while buying a bag of Malt-O-Meal's Golden Puffs at a store in Over-



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land Park, Kan.

Bags are just the latest sign that the ready-to-eat cereal industry is going through wrenching changes. Over the past decade, industry

share of cereal sold in the U.S.—including its boxed brands, such as Life—is 10.1%, up from 8% two years ago, says Donaldson, Lufkin & Jenrette Inc. analyst William Leach.

Whether they're in a bag or a box, the cheapo cereals show just how tired consumers are of paying ever higher prices for a relatively unexciting product. The knockoffs—with comically ripped-off names like Rice Crisps and

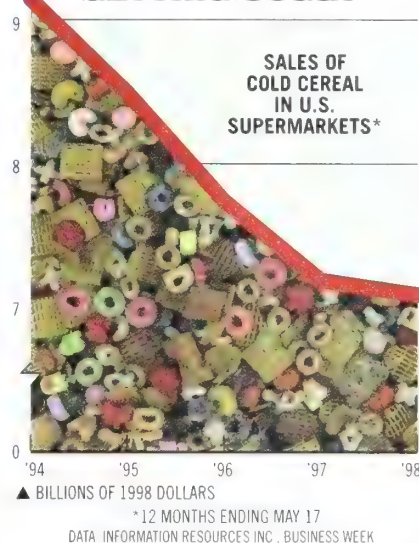
Frosted Flakers—are stealing market share despite some major disadvantages. Not everybody agrees with Kansan Buchner about the taste. Kids sometimes complain that they don't have a box with games or cartoon characters. And the zipper-like bags can be difficult to close or store. The growth of these low-end products shows how out of step cereal giants have been with shoppers' preferences. In fact, few consumer products have suffered more in recent years than ready-to-eat cereals.

For Quaker, bags are to some degree an admission of defeat. Referring to the industry's habit of pushing expensive cereals backed by costly ad blitzes, Quaker CEO Robert S. Morrison told an industry conference earlier this year: "The days of 'high price, high spend' in the cereal category are perhaps over." That's bad news for the big marketers. Margins on bagged cereals are thin as a corn flake, about 3% to 5%, vs. 15% for branded, boxed products.

PAINFUL SLIDE. Still, what it has lost in margins, Quaker has more than made up in volume. Brisk sales of its bagged products helped push its second-quarter operating income from ongoing businesses up 14%, to \$199 million. During the same quarter, Kellogg's profits fell by 17%, to \$143 million.

The inventor of "Snap, Crackle, Pop"

GETTING SOGGY

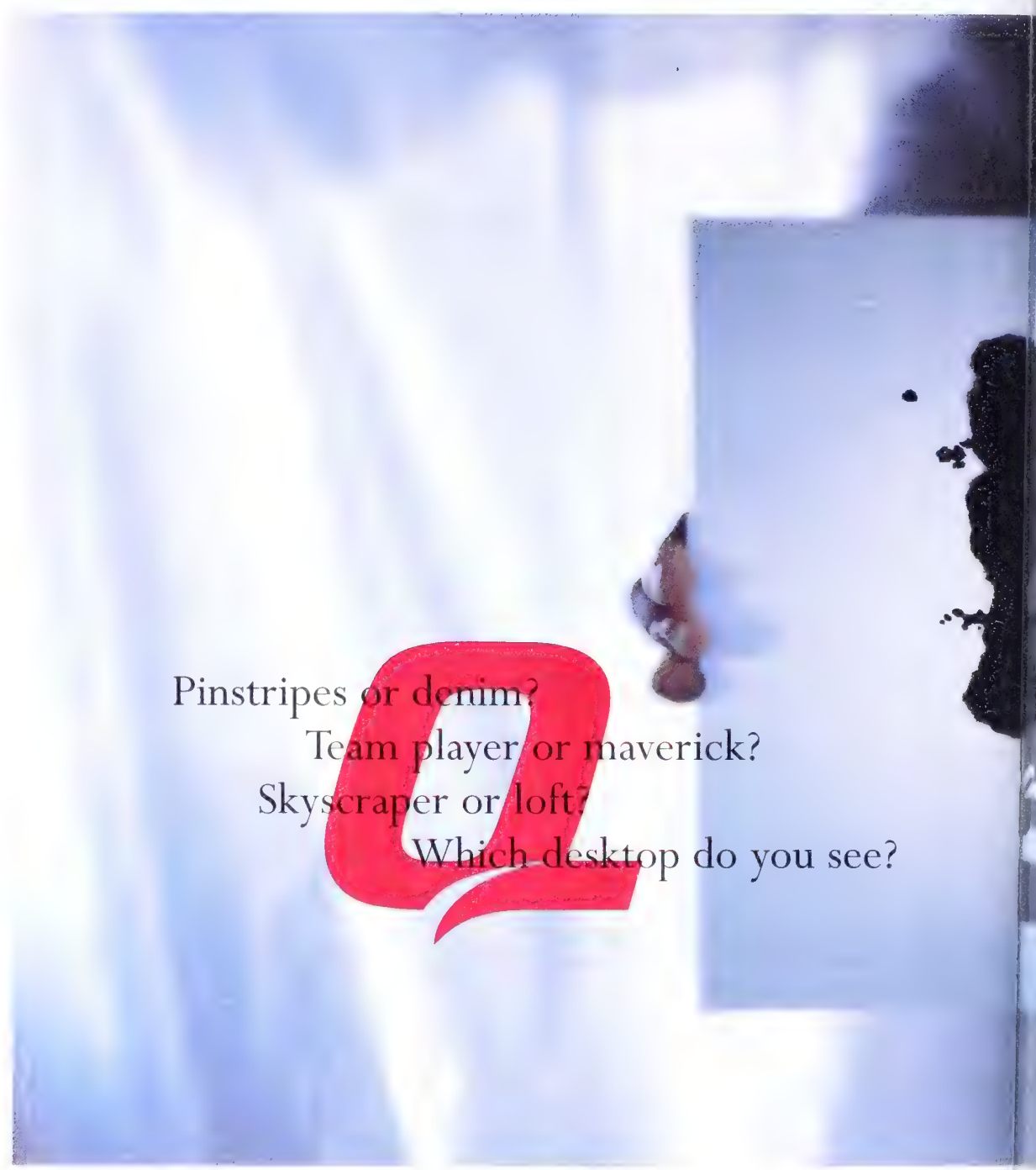


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Marketing

as a new plan to fight back, but unlike Quaker, it's not willing to dent margins by adding a cheaper cereal line. In June, 4-year-old Carlos M. Gutierrez, a 23-year Kellogg veteran who had headed up global business development, vaulted over execs at bigger units to become president—and the leading candidate to replace Arnold G. Langbo as CEO. Kellogg plans to cut \$100 million in annual costs, probably through layoffs, and use the savings to boost ad and promotion spending. It recently invited five ad agencies to submit new marketing ideas. Kellogg executives declined to comment on their plans.

Kellogg's painful market-share loss, from 38% to 32% since 1994, has left industry-watchers skeptical it can persuade more consumers to pony up for agnate brands like Fruit Loops and

Kellogg's strategy:
Cut costs, boost ad spending—but hold the line on price

Flakes. Since 1995, Rice Krispies has lost more than a third of its market share and Apple Jacks about one-sixth. To make its marketing blitz pay, Kellogg hopes to come up with some blockbuster products. Kraft Foods Inc.'s Post is—the No. 3 cereal maker—is the only one of the Big Three to show a sales gain over the past year, according to Information Resources Inc. Post got a boost from new products like Oreo, launched this summer with a big-than-normal \$40 million campaign. The pressure on the big marketers is likely to let up soon. Private-label cereals, which right now come mostly in generic versions in the last five years, still have room to grow. Altogether, generic products are responsible for less than 12% of the cereal segment—compared with about 20% of the cracker, cookie, and nuts category.

Indeed, generic powerhouse Ralcorp Holdings Inc., which now holds a 55% share of the private-label boxed category, may try to muscle in on the bagged market. Said Ralcorp CEO Joe R. Heletto, speaking to a group of analysts in June: "We are seeing more and more retailers asking for store-brand sales." That could soon mean even more name rivals for Tony the Tiger.

By David Leonhardt in Chicago, with email reports

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MERCK TAKES SOME GROWTH PILLS

It says new drugs should allay investors' fears



To hear Raymond V. Gilmartin tell it, drug industry leader Merck & Co. is poised to do the unthinkable. In the years 2000 and 2001 Merck will see U.S. patents expire on five big drugs that will be generating about \$5 billion in worldwide sales. Other giants that have faced patent expirations on blockbuster drugs have seen sharply lower revenues and earnings growth as cheaper generics gobble up sales. But Gilmartin contends Merck's stable of new drugs will more than offset the drop, allowing it to generate growth rates competitive with industry leaders. "Merck has defied conventional wisdom before," he asserts.

That confidence, however, hasn't spread to Wall Street, for good reason. Some of the new products are off to slower starts than expected. Moreover, technology advances have accelerated drug development times. That means similar, or even superior, drugs are going up against Merck products faster than ever. And while Merck's prowess at launching products is proven, it has shown less impressive results in defending some key markets. "You have to assume nothing goes wrong," says James C. Baker, portfolio manager at ARK Asset Management Co., a Merck institutional shareholder. "It's not a sure thing."

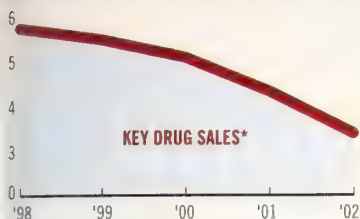
REVVING UP. The bottom line: Analysts and investors are increasingly concerned about the possibility of a major slide in Merck's growth rate. While the company saw both sales and profits grow 19% last year—bringing sales to \$23.6 billion and net income to \$4.6 billion—SC Cowen analyst Stephen M. Scala figures sales growth will drop to 8% in 2001 and 6% in 2002. He expects net income growth to slow to 9% and 6% in those years. Although still decent—Glaxo Wellcome's saw income climb just 3% in 1997, when its Zantac went off patent—such rates would lag industry leaders, which are expected to grow in the teens.

Merck's stock, priced around 130, reflects that expectation. It trades at a price-to-earnings ratio of 26.5, based on 1999 earnings expectations. The average drug stock now has a p-e of 31.5.

But if Gilmartin is worried, he doesn't show it. He insists that much of the investment community underestimates the earnings power of Merck's portfolio. "It is very difficult for people on the outside to get a good handle on how big the drugs could be." And he has been proving that engine since he took the helm in June, 1994. Gilmartin has cut oper-

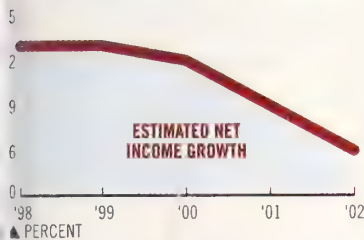
CONFIDENCE: Gilmartin and Scolnik have faith in Merck's pipeline

AS KEY U.S. PATENTS EXPIRE...



EXPECTED WORLDWIDE SALES FOR MEVACOR, VASOTEC, PRINIVIL, AND PEPICID, AND MERCK'S PORTION OF U.S. PRILOSEC SALES

MERCK COULD GET A CHILL



DATA: SG COWEN

and overhead costs—by \$350 million total in 1995 and 1996—and pumped that money back into research and marketing. At the same time, he unloaded non-growing or peripheral businesses and generic drugs. He unwound a joint venture with DuPont Co. that would have been a drag on earnings and re-secured a deal with Astra AB to give Merck more revenues and a minimum payout of \$6.3 billion if Astra buys out Merck's share.

IF WARS. Under longtime research chief Dr. Edward M. Scolnick, Merck continues to turn out plenty of potential candidates. There is buzz in the industry for a new antidepressant under development could be a blockbuster when it hits the market as early as 2001. Still, it probably won't arrive in time to make a meaningful contribution in the critical patent-expiration years. In that period, Merck will be leaning on its newer drugs, including five rolled out in the last year: the prescription painkiller Vioxx, which should arrive in mid-1999. Most of the launches are meeting expectations, though sales of the Propecia hair-loss drug have been slower than analysts expected, possibly because most big HMOs won't pay for it.

While Merck continues to excel at opening open markets in need of innovative therapies, a boom in drug development technologies has shortened the time that those pioneering drugs have exclusive grip. Take Merck's Crixivan, one of the first of the "protease inhibitors" that has successfully suppressed the AIDS virus when taken with other drugs. Sales of Crixivan are expected to near \$700 million this year, but they have slowed significantly in

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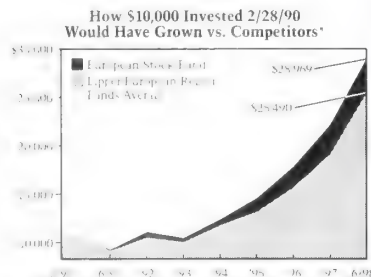
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SAUCONY

ie face of competition from Viracept, a rug produced by biotech upstart Agouron Pharmaceuticals Inc. Viracept ow shares the No.1 spot in the U.S. ith Crixivan in part because patients on't have to stick to Crixivan's rigid dosing schedule. "Maybe they didn't ke us seriously enough," says Agouron chairman Peter Johnson.

If that isn't enough cause for concern, another recent beating has Merck catchers questioning the company's ability to defend the turf of its more established drugs. Merck pioneered the category of cholesterol-reducing drugs and w sales of its newest entry, Zocor, ar to \$3.6 billion last year. The primary reason was a landmark—and cost-

The pain reliever Vioxx could be huge, but Merck will have to fight for the market

—Merck study in 1994 showing that e product saves lives and prevents art attacks and strokes in people with art disease and high cholesterol. But 1997, Zocor's heady growth tumbled h the arrival of Lipitor from Warner- mbert Co. Warner teamed up with g-marketing powerhouse Pfizer Inc. quickly grab the top spot. At the l of the June quarter, Lipitor had a % share, vs. Zocor's 24.5%, says mar- research firm IMS Health Inc.

IT MOVES. Lipitor's big advantage is t it is a more potent drug. Still, its ninance—and Zocor's stunning set- k—has as much to do with marketing with potency. For one thing, Merck n't expect Warner to get accelerated roval. But Warner made a convincing e to the Food & Drug Administra- and hit the market in February, 7—about six months earlier than exted. Merck hadn't completed its ined expansion of the Zocor sales e. As a result, Warner and Pfizer— a combined 2,700 sales reps to pro- e the launch—outgunned the roughly 0 people pushing Merck's Zocor, ac- ling to research firm Scott-Levin. ut Warner didn't stop there. Exten- market research showed physicians e concerned about lowering triglyc- e levels in the blood as well as cho- erol. So Warner sought and received J. K. from the FDA to note on its la- that Lipitor was proven to do both. le Zocor also lowers triglycerides,

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erck didn't initially ask to say that prominently on its label, in part because lowering triglycerides isn't proven to be a major benefit in most patients. So Merck sales reps couldn't promote the point with doctors. Lipitor's claim "was the cherry on top of the sundae," says Warner-Lambert Vice-President John Alexy. Merck followed suit in November, 1997, but Warner and Pfizer had months to exploit the difference. Gilmartin says the Zocor debacle taught Merck important lessons. For one, Merck is doing more research on factors affecting physician decisions. It also got the O.K. for a higher 20-milligram starting dose on Zocor this summer, which tests its cholesterol-lowering ability in line with Lipitor. And it is aggressively counting the drug to big hospitals. "His battle is not over," vows Gilmartin. A big test of Merck's marketing muscle will come later next year when it launches Vioxx. The painkiller, part of a new class called Cox-2 inhibitors, is likely to be huge. The Cox-2s are expected to provide the same pain relief as prescription nonsteroidal anti-inflammatories—stronger versions of Advil-like drugs—but without side effects such as stomach bleeding. "It is as good a drug Merck has ever made," says research analyst Scolnick.

BET. But Vioxx is likely to be second to market, trailing a G.D. Searle & drug by four to five months. There, Merck will again square off against Pfizer, which has struck a deal to co-promote Searle's drug. Gilmartin won't discuss marketing plans, but he points out Vioxx has one critical advantage. Vioxx is taken just once a day, vs. twice a day for its rival. Analysts expect the drug to generate billions in revenues, which is key to filling the patent hole. Vioxx is the single most important factor in the three- to five-year outlook for Merck," says Norman M. Fidel, senior vice-president at Alliance Capital Management L.P., a big Merck investor. Some analysts think Gilmartin should hedge his bets with co-marketing deals similar to the ones struck by Warner-Lambert and Pfizer. But Gilmartin says Merck's cash flow is rich enough that he can go it alone. "The best use of our resources and time and attention is to grow through internal development rather than through mergers and acquisitions," he insists. It's a risky bet with little room for error. One stumble and a chastened Merck may find it needs a radically different prescription for growth. *by Amy Barrett in Whitehouse Station, N.J., with Larry Armstrong in Los Angeles*

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ON PAGE 158

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In Box page 2

Tip Sheet Reassessing Gen X, help for women entrepreneurs, software to speed the Web, and more

Internet page 4

Hey, Look Me Over

Luring customers to your Web site isn't easy, but there are ways to make them click

Companies page 10

Boom! Eddie Cheever, winner of the Indianapolis 500, was the only owner/driver in the race. Now, his 50-year-old race team is becoming a sports-marketing machine

Management page 12

Heart Medicine New group purchasing plans for small business are helping to make health insurance cheaper—and giving workers more choice



Finance page 16

A Loan At Last? When your friendly banker says no, it pays to know the ins and outs of computerized credit reviews



My Company page 20

Let's Talk About Sex How to prevent harassment issues from blowing up? A tough, clear policy helps—but it may not be enough

Buyer's Guide page 22

Courting Agreement Litigation isn't the only way to resolve disputes. Where to find the best arbitrators and mediators for small business

Under 30 page 26

Early Bloomer Jared Schutz is an idea man, an entrepreneur, a techie. He sells flowers on the Net, invests in up-and-coming Web sites, and starts up companies whenever it strikes his fancy. Oh, by the way—he's 24



IN BOX

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CUTTING GEN X SOME SLACK

The much-maligned slackers of Generation X are starting to get some respect. In the latest survey from Key Corp., 69% of small-biz owners gave Gen-X employees low marks for work ethic, but 75% said they are educated as well as—or better than—previous generations. Also, 59% said Gen-X workers are at least as competent as older workers, up from 48% two years ago. Why the change? Small businesses are more wired—89% of small-biz execs reported using PCs, up from 69% a year ago—and younger workers are more comfortable with computers. Three in five business owners admitted Gen Xers have better technical skills than earlier generations.



IS IT ETHICAL? PERCENT SAYING "NO"

MANAGERS ENTREPRENEURS

TAKING LONGER THAN
NECESSARY TO DO A JOB

78% 91%

TAKING EXTRA PERSONAL TIME

57% 80%

HIRING COMPETITORS' EMPLOYEES
TO LEARN TRADE SECRETS

63% 74%

AUTHORIZING EMPLOYEES
TO VIOLATE POLICY

86% 95%



THE STRAIGHTEST ARROWS

A study of some 300 business owners and corporate managers by nonprofit research group RISEBusiness finds that entrepreneurs generally have stricter ethical standards than managers. They're also better able to live by their beliefs, probably because they have more control. Just half say they sacrifice personal ethics to the goals of business, compared with 71% of corporate types.

DATA PROVIDED BY RISEBUSINESS

PITCHES THAT ARE PACKED WITH ADVICE

Corporate America wants YOU, the small-biz owner, and is offering free tip sheets as a lure.

Intuit's "Recipes for Success" dishes out maxims from state winners of the Small Business Administration's 1998 Small Business Person of the Year award (877 213-7477).

Visa and the Service Corps of Retired Executives offer "How to Secure Financing" and "How to Choose the Best Bank for Your Business," with advice, Web resources, and case studies (800 634-0245).

Sprint's "A Day in the Life of a Small Business Owner" offers five pages of productivity tips and quirky statistics (877 711-4485).



SO THEY SAY

"It no longer mattered whether I was a man or a woman.... I worked hard and my credit was good."

— Bonita Schwartz, who was turned down by a loan officer but O.K.'d by a computer (page 16).

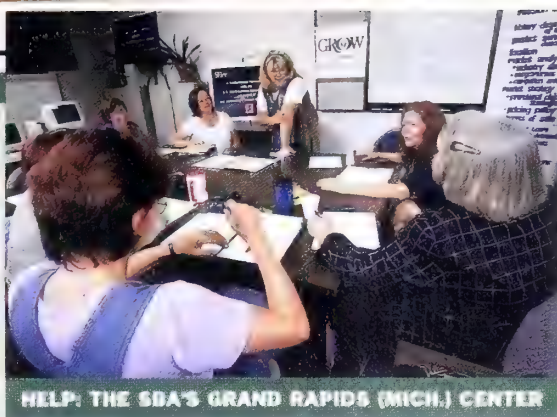
CAREFUL—YOUR HEAD MAY BE GROWING

Entrepreneurs need self-confidence to succeed, but they may be deluding themselves about their abilities. Professors Larry W. Cox of Florida International University and St. Sommer of the University of Nebraska looked at factors that entrepreneurs

NEARLY 50% OF 400 SMALL-BIZ OWNERS POLLED BY PADGETT BUSINESS

WOMEN'S MOVEMENT

The opening of six new women's business centers in the Small Business Administration now has 70 locations around the country where women entrepreneurs and wannabes can get financial advice, marketing advice, technical training, and more. Most centers are run by local women-owned nonprofits in partnership with the SBA. For locations, visit www.onlinewbc.org/docs/index.html, or call the Office of Women's Business Development (202 205-6673).



HELP: THE SBA'S GRAND RAPIDS (MICH.) CENTER

REAL-WORLD READING LIST

What works in business? Progressive Business Publications offers plenty of pointers in its family of twice-monthly newsletters—such as *The Marketing*

Report, *What's Working in Credit & Collection*, *Facility Manager's Alert*, and *Keep Up To Date on Payroll*. Each issue of PBP's 22 quick-read publications offers a wealth of bite-size tips, resources, real-life case studies, and statistics. From \$94 to \$399 per year (800 220-5000).

THE STATES OF SMALL BUSINESS

For business owners, the Small Business Survival Committee feels strongly about taxes. The conservative lobbying group recently ranked the business environment in each of the 50 states (and D.C.), based on "government-related costs"—specifically, 10 types of taxes and the crime rate. Infrastructure regulation are not yet part of the formula, but the SBSC is working on a way to quantify those costs, too.

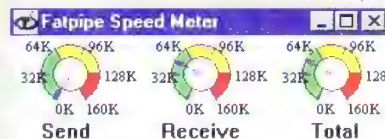
SMALL BUSINESS SURVIVAL COMMITTEE



believed led to the success or failure of their companies, which averaged 10 workers and \$1.4 million in sales. The result? Most entrepreneurs attribute success to their own efforts and talent, but blame failure on outside forces, such as bad luck or hard times. The danger is that owners who do so won't get needed help, while those taking undue credit for success may be unprepared for a downturn. Get a reality check from reliable outsiders, the authors suggest—a lawyer, a banker, or an advisory board.

SPEED THE WEB

Are slow-loading Web pages bogging down your business? Now there's software that lets multiple modems and phone lines work as one, speeding transmission without the cost of additional high-speed lines.



Newly launched FatPipe 3.0 merges four telephone lines or two integrated service digital network (ISDN) lines into

a single high-speed Net link that up to 50 users can access through a local-area network. The office version is \$299. The home version, which supports five users but lacks some features, is \$49 (Ragula Systems Inc., 801 281-3434). Also consider Shotgun from Diamond

Multimedia (800 468-5846) or MidPoint Teamer from Boca Research Inc. (561 997-6227). Both combine two modems/phone lines to double transmission speed. Either program is free with a modem from Boca or Diamond (about \$140), but Internet service providers may charge extra to support the service.

For more on net speedups, visit enterprise.businessweek.com

CEOS SAID THEIR HIGHEST-PAID EMPLOYEE EARNS LESS THAN \$25,000

IT'S A HONEY OF A WEB SITE, BUT WHERE'S THE BUZZ?

Luring customers to your URL can be tricky. Here's how to make them click

A year ago, tiny James River Drums of Richmond, Va., joined the thousands of businesses that stake out new turf in cyberspace every day. Founder Dennis Johnson, who chucked a 16-year career as a purchasing manager at an engineering firm to sell African-style hand drums, figured his spiffy \$3,000 Web site would generate sales around the country—even the world.

But weeks passed, and Johnson's Web site drummed up nary a customer for

the home-based business. He had no idea why—until a Web-savvy friend gave him some seemingly obvious, yet often ignored, advice: It's fine to have a site, but you've got to bring people to it.

It's easy for a Web site to get lost in

cyberspace. "I think that most businesses come to the Web with really high expectations, and they are learning it's not 'build it and they will come,'" says Ken Allard, group director of site operations strategies at Jupiter Communications LLC, a New York computer-industry consulting and analysis firm.

Of course, legions of pricey consultants stand ready to help "drive traffic" to your Web site. But budget-minded small companies are learning to p





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this game, too. They're opting for cheaper—and often more creative—solutions, judiciously spending limited promotional dollars to market their sites, buying consulting services à la carte for specific technical tasks, and relying on some free, grassroots approaches.

In Johnson's case, some fairly simple technical changes on his Web pages help people find the James River site when they search for "African drums." The fix, performed by a consultant for just \$150, entailed refining "meta tags," the special coding on Web pages that enables search engines to find them. His traffic grew from virtually nothing to anything from 85 to 140 visitors a week—enough to generate about 60% of his still-modest sales. (He gets the rest through free drumming demonstrations in his area and some print advertising.)

Where do you begin? There are hundreds of Web sites that offer free or low-cost help to boost Web traffic—everything from sites that will register you with multiple search engines to so-called link exchanges for swapping ads with other sites (table). "No single thing will make your site successful," says Syd Rubin, a partner in e.magination network LLC, a Baltimore Web hosting, design, and promotion firm. "It's doing all of the little things."



HEY, LOOK ME OVER Direct mail and broadcast ads work for some. Others publish their own E-mail newsletters

For starters, you should register your Web site with the leading search engines—Alta Vista, Excite, InfoSeek, WebCrawler, and Yahoo!—by filling out a registration form at their home pages. Alternatively, you can register for many search engines at once at sites such as www.register-it.com. Old-fashioned, non-tech marketing works, too. Haddonfield Running Co., a two-store running-gear outfit in Haddonfield, N.J., started a stampede to its Web site by putting its Web address on, well, everything. "We listed our Web site on our cards, on the front of the store, with the logo, on the bags, on the bottom of every sales slip," says Chairman Joe Puleo. While he doesn't benefit from online sales—the shoe and apparel manufacturers prohibit it—he attributes a 15% increase in his in-store sales to runners who visit his Web site, attracted by useful content

such as race registrations and hearing tips for runners.

Carl Delmont, president of Freedom Mortgage Corp. in Hunt Valley, Md., used both direct-marketing brochures and local TV and radio advertising to publicize his finance company's Web address, or URL. Monthly traffic jumped from 1,000 to 3,000 hits, which Delmont says generate about 120 applications.

Still other Web-site businesses have managed to promote themselves by publishing their own E-mail newsletters, which go directly into subscribers' mailboxes, or sponsoring somebody else's. To find a newsletter to sponsor, try a Direct E-mail List Source (www.copywriter.com/lists), which compiles names and Web addresses of newsletters, E-mail lists, and brokers who place ads in the appropriate newsletters. Eric Targan, the New York City

LOST IN CYBERSPACE?

Here is a sampling of Web resources to help drive traffic to your site

● SEARCH ENGINE REGISTRATION

WWW.REGISTER-IT.COM

Will register you free at 16 search engines, but not the top ones.

WWW.GONETWIDE.COM/GOPUBLIC.HTML

Links page connecting to a couple of hundred registration and announcement services and Web resources.

● DIAGNOSTICS

WWW.SITEOWNER.COM

For free, checks the Web page coding that search engines use to find a site. Part of search registration site Submit-it.com.

WWW.WEBSITEGARAGE.COM

Web site tuneup, offers both free and paid services.

● WEB RINGS

WWW.WEBRING.ORG/#RINGWORLD

Lists a huge number of Web rings where you can place your site.

● BANNER ADS

WWW.LINKEXCHANGE.COM/WEBRESOURCE/WRC1.HTML

Site for swapping ad banners; also has links to online tutorials.

WWW.FLYCAST.COM

Matches buyers and sellers of discount banner ad space.

● SEARCH ENGINES

WWW.SEARCHENGINEWATCH.COM

News and links to other resources; good how-to tips on using search engines.

WWW.MONASH.COM/SPIDAP.HTML

Tips on using search engines, with ratings.

● FREE LINKS

WWW.BARNSIDES.COM/LINKS.HTM

A roster of sites, directories, and search engines that allow you to list your Web site for free.

WWW.100HOT.COM

Lists popular sites by category; good for link prospects

Home Run.

"On Time for America's Pastime."



It was a real pressure cooker for Rawlings Sporting Goods. With just a few days to **produce and deliver** the **Special Edition Baseballs** for the premier event of America's favorite pastime in New York and Atlanta, Jeff Wilson, Rawlings' Distribution Manager, penciled Roadway into his lineup.

Roadway Sales Representative Chris Hollis **arranged for a pickup** as the balls rolled off the production line and **coordinated the shipment** from Rawlings' St. Louis, Missouri, home in plenty of time **before the first pitch.**



As Jeff put it, "Rawlings ships baseball gloves, bats and all of the baseballs throughout the major and minor leagues each season, and no matter how many curve balls we throw at them, **Roadway never misses.**"

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enterprise.businessweek.com

Business Week Online has expanded its site for small-business owners and executives. Now you can get news every day on topics important to you, plus an array of databases, story archives, and business tools.

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TECHNOLOGY

Find the best computers, office products, and services, and learn how to manage them.

BENEFITS

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ENTERPRISE

Internet

based owner of E-mail Marketing News and the 200,000-subscriber Joke of the Day E-mail list, says reaching a list of random subscribers generally runs \$20 for each 1,000 readers. More targeted audiences cost up to \$300 per 1,000.

For some free self-promotion, many entrepreneurs participate in Usenet bulletin boards and subscriber-based E-mail discussion lists, or "listservs." (To find and subscribe to such groups, try www.dejanews.com or www.liszt.com.) After posting a comment, sign off with a "signature file," or "sig," that includes your URL and perhaps a favorite saying or a free offer. "Make 'em laugh; shock 'em; get their attention somehow," says Lisa Hickman Bryan, whose Indialantic (Fla.) marketing and public relations firm, Word Works, has found 98% of its clients through postings.

"Swapping" links with other Web sites is effective, too. You can do this informally, by inviting other sites to link to yours in return for your linking to theirs. Or try joining a "Web ring," a group of sites, usually addressing a common theme, topic, or audience, that allows the surfer to click from one to the other. You can search 44,000 rings at the Ring World directory, run by the site WebRing. Then, visit the home pages of rings you'd like to be a part of. A "ringmaster" determines whether you can join.

Do Web rings work? John Newport, 27, co-president of Newport Industries International, an office-supply and electronics wholesale operation in Oak Harbor, Wash., used a search engine to find Web rings about electronics. He says that by joining several of them, he increased Web sales tenfold, to \$50,000 a month. "As soon as I got on them, I got 37 extra E-mails from people who wanted camcorders," he says.

Sometimes, however, nothing targets your market like a well-placed banner ad. Banners, put on Web sites and the pages of search engines, link directly to the advertiser's Web site. @Backup, a San Diego company that backs up computer files sent over the Internet, frequently buys banner ads, sometimes trying out different ones to see which draw the most traffic, says Chris d'Eon, the firm's marketing director. You can also have your banner ad appear on a search engine's Web page by purchasing a specific "key word." The ad pops up

when someone searches for the word. Barewalls Interactive Art LLC, a Cambridge (Mass.) company that sells about 200 art posters a day over the Web, spends most of its promotional budget buying words like "poster."

Lorne Lieberman, the company's marketing director, says the ads attract motivated customers "with dollars to spend" right away.

The cost for key words generally ranges from \$35 to \$85 for every 1,000 times the word is used, says Leonard Bilello, senior account executive at DoubleClick Inc., which sells key words. Alta Vista. But if you want banners the cheap, try one of the so-called banner exchanges, such as LinkExchange, that let you swap ad space on someone's site for space on yours. Or, you

DOUBLE TAKE: A "banner" on a Web site or search engine can get results



can go to a banner repackager, such as Flycast Communications Corp., which sells banner space at a discount. One caveat: You can't always control where your ad appears.

For more control, you're better off buying banners directly from a site in your favor. It's typical to pay \$3 to \$5 for every 1,000 banners displayed, or as much as \$10 to \$15 per 1,000 for more targeted audiences. To create those banners, graphic designers charge anywhere from \$50 to \$1,000 apiece. The smaller, cheaper agencies are often a better bet. "They won't put a full-motion movie on your banner that bogs down the viewer's machine. People don't buy from that," says @Backup's d'Eon.

Indeed, trying a bit of this and that is what this elusive art of Web site promotion is all about. Of course, if you do want help, there's plenty out there. A search of Yahoo! unearthed a new category, Web services. It has 7,809 sites... and counting.

By Roy Furchgott in Baltimore

To learn more about Web ad networks, visit enterprise.businessweek.com

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FROM COCKPIT TO CORNER OFFICE

Eddie Cheever is a top driver—and a driven businessman

Veteran auto racer Eddie Cheever Jr.—winner of this year's Indianapolis 500—took a crash course in entrepreneurship on his journey from driver-for-hire to business owner. The first Indy winner since 1977 to own his team, a company called Team Cheever Motorsports, Cheever has done well on and off the track. But in July, Cheever the businessman balked at paying tens of thousands of dollars for a one-race insurance policy with a \$50,000 deductible. Days later, Cheever the driver smacked into a wall at 200 mph, demolishing a \$400,000 car, breaking a \$120,000 engine in two—and walking away much the wiser. The mangled assets now sit in the “corner of horrors” of Team Cheever's Indianapolis headquarters, a reminder of the perils that await any startup, particularly those with 700-horsepower engines.

For the most part, though, Team Cheever is having a banner year. The crushed car was the same one he drove to victory on May 24 at Indy. Also in the money, four cars behind, was the team's No. 2 driver, Robby Unser. Their combined earnings pumped \$1.64 million into the two-year-old company, whose revenues last year were \$8 million.

IN THE CHIPS. More important, Team Cheever's Indy run was seen by 90 million viewers, delivering a mother lode of media exposure for all-important sponsors who pay up to \$5 million a year to use his racing operation for advertising and promotion. “They pay the way,” says Cheever, who views his team as a marketing company first and sporting venture second. “I don't include one pen-

ny of prize money in my budget projections because the racing gods are too fickle.” His 20 full-time employees are mostly high-tech mechanics. But they also include a marketing manager who helps sponsors get the most out of their affiliation with auto racing—from logos on the hood to lunches with Cheever—and a “hospitality manager,” or pit-stop concierge,

ENTREPRENEURS



YOUR AD HERE
Cheever views his team as primarily a marketing venture

benefits by taking a chance on a new owner-driver in an upstart racing league. A previous sponsor had jumped ship, and the Minneapolis-based snack food maker signed on just 10 days before the

big race. To bring Rachel's on board, Cheever had to execute some flashy maneuvers. First, he persuaded an associate sponsor, Midwestern hardware chain magnate John Menard, to carry Rachel's at his 138 Menards stores. That virtual guarantee of Rachel's sponsorship investment would be covered before a single race was run.

The Indy win turned out to be a lightful double-dip for Rachel's. National print and TV coverage provided exposure worth \$6 million to \$8 million, those with their brands on the victor's car, according to Ann Arbor (Mich.) marketing researcher Joyce Julius & Associates. “Since Indy, our phones have been ringing off the hook. Our chip sales have doubled,” says James M. Garlie, president of RLD Enterprises Inc., parent of Rachel's brand. Garlie has also cashed in on Team Cheever's success by

UNDER THE HOOD

COMPANY Team Cheever Motorsports, 20-employee open-wheeled Indy car-racing and sports-marketing team based in Indianapolis. Founded in 1997. Revenues last year: \$8 million. Projected for 1998: More than \$10 million.

OWNER 1998 Indianapolis 500 winner Eddie McKay Cheever Jr., 40 (a.k.a. $E=mc^2$).

BUSINESS Sports marketing of two race cars, two drivers, 11 IRL races, and related events as advertising and marketing opportunities

GOALS Attract bigger-name sponsors with deeper pockets while providing wider opportunities for existing sponsors. Form strategic alliances with auto makers and component manufacturers.

BIGGEST CHALLENGE Competing for sponsors from other racing teams with higher profiles in more established racing series such as CART and NASCAR.

parking his marketing to the 10 corners where the racers compete.

Courting sponsors is second nature to Cheever, 40. Born in Arizona, he moved to Italy at 4, when his father opened a chain of fitness centers across Europe. Little Eddie soon earned his racing stripes, winning the European and Italian go-cart championships at 15. His formal schooling ended six years later when he signed a \$500,000

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FLORIDA	INDIANA	MINNESOTA	OREGON	Richmond	Toronto	Santa Fe de Bogota
Panama City	Indianapolis	(2 locations)	Portland	Wichita Falls	Windsor	
	LOUISIANA	MISSOURI	PENNSYLVANIA	WISCONSIN	ESPEC	
	(2 locations)	Columbia	St. Louis	Appleton	Mexico	
		St. Charles	St. Peters		Guadalajara	
		St. Charles	St. Charles		Mexico City	
		NEW JERSEY	Clark		(2 locations)	
		Clinton	Nashville (2 locations)			

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contract to test-drive racers for Ferrari.

In 1990, he returned to the U.S. to race open-wheeled "Indy" cars in the Championship Auto Racing Teams (CART) series. He earned Rookie of the Year honors in his first Indianapolis 500 that year, but he never got into the winner's circle. Frustrated, Cheever felt he couldn't be a consistent winner until he had full control over the cars he drove—from technology to pit crew.

TRICKY TURN. Opportunity knocked when the Indy Racing League (IRL) was formed in 1996 by a faction inside CART that felt corporate-owned racing teams were running up costs and cutting out smaller rivals. Wanting greater parity, it wrote cost-containment rules that halved the expense of fielding a car. That allowed Cheever to become the IRL's first owner-driver last year. With more than \$1.5 million in startup money from savings and private backers, he fielded a trusted team of racing veterans and marketing pros. Since then, he has been reinvesting his profits and expects to have at least \$3 million in equity by yearend.

Cheever admits that being the boss was frustrating at first. "I stormed out of my office, cursing and swearing and telling my staff that I wish I could go back to just being a driver," he says. "As an owner, I have had to learn that the word 'team' does apply to racing." To complement his skills, he sought the financial, management, and marketing counsel of proven businesspeople. In particular, he relies on minority partner Clyde Perlee, an Indianapolis native and publishing entrepreneur, and Menard, who has his own IRL team but purchased an associate sponsorship of Cheever's car. Other secondary sponsors include Goodyear, Bosch, True Grit, and Pennzoil.

Win or lose, wagering on Team Cheever as a marketing tool appears to be a smart bet. Auto racing has gained 2.5 million fans in the last four years and is now the No. 1 choice for companies involved in sports marketing and advertising, according to the *IEG Sponsorship Report*, a newsletter that tracks corporate sponsorships. Sponsorship revenues have grown to \$1.1 billion (golf is second), so Team Cheever would seem to be on the right track. The owner has visions of expanding as a testing service for car and component makers, and it wouldn't be surprising one day to see a Team Cheever car running with the big dawgs on a NASCAR track. Fast Eddie has learned there are two basic rules of success that apply to both racing and business: Try to stay ahead of the other guys, and always follow the money.

By Wes Smith in Indianapolis

Join Cheever for a live chat October 4 at 9 p.m.
EDT. Go to America Online: Keyword: BWtalk.

ENTERPRISE

Management

HEALTH-PLAN WOES? JOIN THE CLUB

Regional buying groups make it easier to offer benefits



SMOOTH SAILING: Riverboat Cruises can offer employees a panoply of plans

When Anne Herzog started Florida Entech in 1993, she found herself in a bind. To attract employees, her Orlando-based company, which makes rides, displays, and other equipment for theme parks such as Universal Studios, had to offer competitive medical benefits. But Florida Entech, like most small employers, was at a disadvantage in the health-care marketplace. Lacking the clout of large employers, small businesses typically can't negotiate premiums, and their employees get stuck with higher deductibles.

Then she found out about Florida Community Health Purchasing Alliances (CHPA). Since 1994, the state has made it easier for small employers to get insurance by sponsoring regional buying

groups. These groups allow companies to tailor their health plans to employees' needs, while reducing costs and administrative hassles. There are now eight of them—aiding nearly 23,000 Florida employers to date. Herzog can offer coverage to her 40 full-time employees, and it costs 25% less than the cheapest available alternative. As a bonus, workers get a menu of health plans. "CHPA is one of the best programs Florida has ever developed for small business," says Herzog.

Such local alliances are catching on across the country. Today, consumer choice health purchasing groups (CHPGs) are providing relief to benefit-starved small employers in 14 states, covering as many as 750,000 people. Chicago-

HEALTH CARE

TIMELY TONIC: CHPGs can cut costs and workers enjoy more choices

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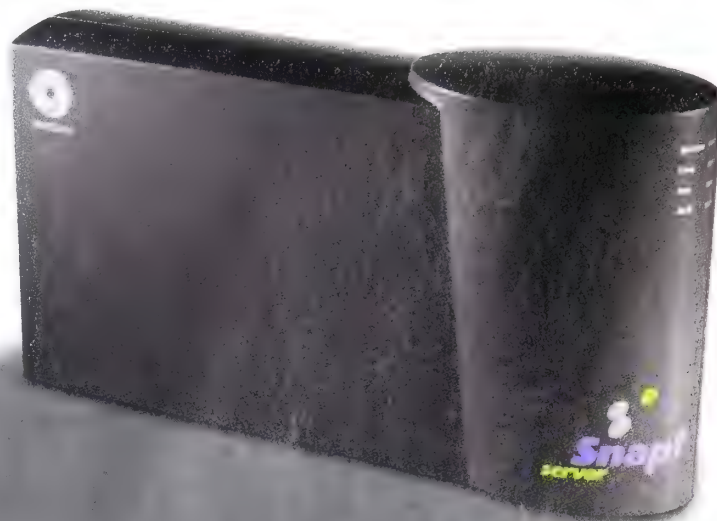
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Management

employers started a group this summer, and in New York City, Mayor Rudolph Giuliani has authorized \$1 million to launch a citywide health purchasing group by early 1999. Several more states have plans in the works (table). Congressional lawmakers are jumping on the bandwagon, too, considering two new bills to bring small employers together to buy insurance. "CHPGs represent a new paradigm in small-business health care," says Kevin Haugh, co-founder of the Institute for Health Policy Solutions in Washington. "I wouldn't be surprised if their enrollment doubled within the next two years."

Small employers who recall how the scandal-plagued multiple employer welfare associations (MEWAs) of the early 1980s ran off with premium payments may be leery of any group-purchasing scheme. But CHPGs are merely intermediaries between employers and insurers and, unlike MEWAs, put premiums in established insurance plans rather than in risky investments.

These newly affordable health plans come none too soon for small businesses competing in tight labor markets amid rising health-care costs. In 1996, only 49% of companies with fewer than 200 employees offered coverage, compared with 99% of companies with more than 200 employees, according to a recent study published in the journal *Health Affairs*. The smallest employers did even worse: Only 42% of firms with 1 to 9 employees offered coverage.

FREEDOM OF CHOICE. CHPGs vary from state to state, and no two are exactly alike. When they first came on the scene five years ago, state agencies played an active role. Nonprofits run the newer CHPGs that have limited ties, if any, to government. Employers pay a nominal fee (say, \$100) to join the group, which handles all the paperwork of administering health insurance and dealing with insurers. Employees then choose from

among all the participating insurers. Most programs require employers to pay at least 50% of the premiums for the least expensive health plan. That keeps employers' costs down, while employees still get access to as comprehensive coverage as they're willing to pay for.

The purchasing groups don't solve all problems in all places; their ability to undercut market rates depends on each state's insurance law. But even in states that regulate premiums, CHPGs can provide savings. Brian Gerhart, president of Riverboat Cruises, a small outfit with 20 full-time employees in Sacramento, saved 25% by joining the Health Insur-

ance Plan of California (HIPC). Gerhart used to offer one expensive plan that tried to "be all things to all people," he says, but now his employees can choose from among 22 options offered through HIPC. A middle-aged employee, for example, opted for generous prescription drug coverage but no well-baby care, while a younger employee chose a plan with excellent pediatric benefits but little catastrophic coverage.

SPREAD THE WORD. Despite its advantages, HIPC, the nation's first CHPG, has not grown as fast as expected. After five years, the California program insures only about 5% of the state's small employers. The reason? Without a hefty marketing budget, the group has not been able to make itself known to about one-third of the state's small businesses. But word is spreading: Small employers can now find out about purchasing groups in the state by going to www.ihsps.org, the Web site of the recently established Institute for Health Policy Solutions. Local chambers of commerce are also good sources.

Perhaps one of the most successful market CHPGs is Connecticut's—no surprise for the home state of the insurance industry. In 1995, the Connecticut Business & Industry Assn. (CBIA) formed a CHPG that now has 3,600 companies enrolled and so far 60,000 people covered. CBIA enrollees can choose from among 17 options offered by the state's four largest insurers: Kaiser, CIGNA, Physicians Health Services, and Aetna.

Danbury (Conn.)-based Maplecrest Software, with 30 employees, joined CBIA last year at the urging of employees who live in nearby New York State. "Our Kaiser HMO plan did not include any New York doctors in the network. Like most small employers, we could not afford to go with several providers," says Karen Doolan, who manages Maplecrest's employee benefits. That may not be the total cure for small business' health-care ills, but so far CHPGs look like pretty potent medicine.

By Joshua Kendall in Baltimore

Mapping Out Health Care

Consumer-choice health purchasing groups are spreading fast, but are not available everywhere. For updates and to contact one in your state, go to the Institute for Health Policy Solutions' web site (www.ihsps.org).

■ IN OPERATION		■ IN DEVELOPMENT		■ BEING CONSIDERED	
CALIFORNIA	✓	KANSAS	✓	MISSOURI	✓
COLORADO	✓	KENTUCKY	✓	MONTANA	✓
CONNECTICUT	✓	LOUISIANA	✓	NEBRASKA	✓
FLORIDA	✓	MAINE	✓	NEW HAMPSHIRE	✓
GEORGIA	✓	MARYLAND	✓	NEW JERSEY	✓
ILLINOIS	✓	MASSACHUSETTS	✓	NEW MEXICO	✓
INDIANA	✓	MICHIGAN	✓	NEW YORK	✓
IOWA	✓	MINNESOTA	✓	NORTH CAROLINA	✓
				OHIO	✓
				OREGON	✓
				TENNESSEE	✓
				TEXAS	✓
				UTAH	✓
				VERMONT	✓
				VIRGINIA	✓

DATA: INSTITUTE FOR HEALTH POLICY SOLUTIONS

ance Plan of California (HIPC). Gerhart used to offer one expensive plan that tried to "be all things to all people," he says, but now his employees can choose from among 22 options offered through HIPC. A middle-aged employee, for example, opted for generous prescription drug coverage but no well-baby care, while a younger employee chose a plan with excellent pediatric benefits but little catastrophic coverage.

All plans offer the same basic benefits, for which Gerhart pays about 75%. But they differ with regard to the doctor/hospital network and the level of copayment. For a single employee under 30, premiums range from \$75 a month for basic HMO coverage to \$165 a month

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LENDING BY THE NUMBERS

Credit-review software is coolly objective. How will you fare?



The night before she was due to receive a crucial loan for her growing business, Bonita Schwartz got a baffling inquiry from her banker. "He calls me at home and says, 'I just want to make sure—you got that business in a divorce?'" she recalls him asking. In fact, she had started the business herself as a single woman, which, she says, he knew. Schwartz took the remark as a put-down, the implication being that she couldn't have started the business on her own. "If I were a man he'd never say such a thing to me," she says. The next day, Schwartz, the owner of a 12-person opinion-research firm, was told she wouldn't get the loan—but not why. Rather than appeal the decision, she moved on to

"find myself a different kind of bank."

It turned out to be very different. Not only were there no intrusive phone calls but this bank also relied on an entirely different kind of application process, known as credit scoring. In the end, she got a \$450,000 loan that enabled Schwartz

Research Services Inc. to build its new Tampa headquarters. Rather than reviewing her business plan, making on-site visits to the company, and looking over years of audited cash-flow statements, the bank used a computerized program to make the decision. Schwartz filled out a simple application form, and the computer toted up pluses and minuses to gauge the risk, weighing such

factors as her years in business and promptness in paying bills. Then, it calculated a three-digit score. "It no longer mattered whether I was a man or woman. What mattered now was that I worked hard and my credit was good," says Schwartz.

FAST LANE. Looking for a small-business loan? Chances are, if you approach a major national bank these days, or even a big nonbank lender, you too will be judged by the numbers. The computerized process of credit scoring has expanded the pool of small-business lenders by making it profitable for them to make loans under \$500,000. Credit scoring reduces the processing costs and screens out bad risks for the big banks, enabling them to offer lower interest rates to borrowers with good scores and higher rates to those with less-sterling scores. Twenty-three of the top 25 small-business lenders—mostly major banks—use credit scoring, according to Fair Isaac & Co., San Rafael, Calif., the leading provider of credit-scoring software. The process originated in the early '90s to evaluate business-credit requests and began to spread among big lenders about three years ago. Most likely, you'll never hear the term credit scoring at all, but the tip-off will be a shorter application and loan-processing time.

How do you know if credit scoring will be helpful to you? Certainly, many people who can't get bank loans benefit from this by-the-numbers approach because it gives more weight to personal credit history than do traditional lending

BORROWING

policies, proponents say. But its cold-blooded objectivity is not for everyone. While a computer program doesn't consider race or gender, reducing the possibility of discrimination by lenders, it also won't cut you any slack for your ability to rise above personal tragedy, such as an illness that has bankrupted your family, nor will it consider such subjective aspects of your character as your deep roots in the community, as a neighbor

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BY KEVIN KELLY

KEEPING PEACE ON THE FLOOR

Our strong anti-sexual-harassment policies work, but we still have to wrestle with plenty of ambiguity

Almost every small-businessperson I talk to is terrified of being sued for sexual harassment. They constantly fret over whether some objectionable employee behavior is going to land them in court and cost them thousands of dollars in settlement costs. Indeed, two years ago, my family business, Emerald Packaging Inc., settled a sexual-harassment case a former employee filed against our company and one of our supervisors. Including legal and settlement costs, the bill topped \$40,000.

So the Supreme Court's landmark ruling on sexual harassment earlier this year was more than welcome. The Justices laid out general rules for employers, saying they could usually avoid liability in harassment cases by showing they tried to prevent harassment and took fast action to stop noxious behavior. The court also ruled that plaintiffs had to take advantage of company programs designed to investigate harassment claims before rushing off to file lawsuits. At last, there was a road map to avoid landing in court on harassment charges, valid or invalid.

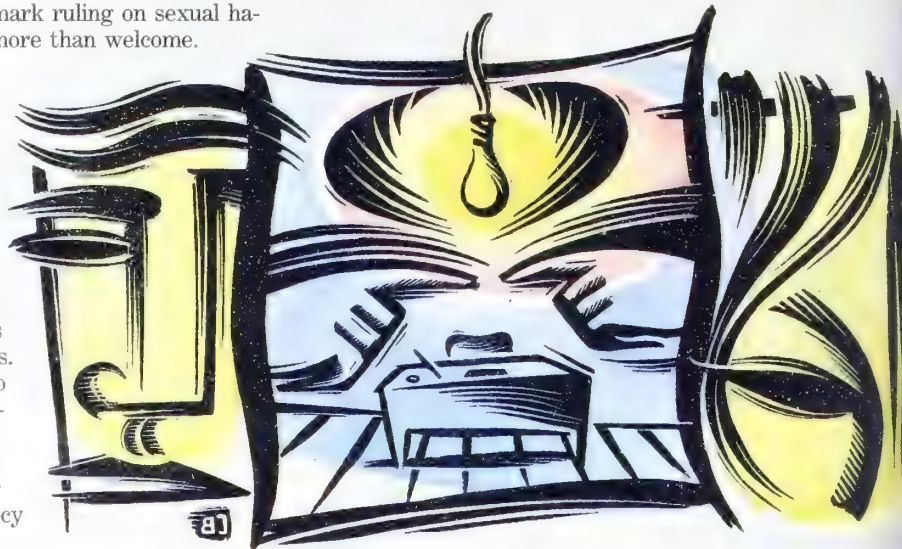
OUT IN FRONT. Fortunately, the court's thinking was close to our own. We have a harassment policy in our employee handbook that lays out a complaint procedure and disciplinary measures and states that no one reporting harassment will face retaliation. When I wrote the handbook two years ago, I had placed the policy toward the back, but our attorney moved it up to No. 3. "You want everyone to know just how important you think this is," he told me.

It was good advice; the Justices, too, want such statements prominently displayed. We go even further: Every new hire has to sign a statement saying he or she understands that we don't tolerate harassment and that we'll investigate every case and take disciplinary action when needed. We post our policy on the bulletin board, and I remind employees about it at plant-wide meetings.

The aggressive stance seems to have worked—no lawsuits since. But perhaps more telling, at least five employees have stepped forward to complain about harassment—from a male employee pressing a female co-worker for

dates to inappropriate touching by a male employee. Each case has been investigated by our team (me, the plant manager, the office manager, and my sister—two men, two women). The process includes interviewing the accuser, the accused, and any witnesses. I take notes and write up the findings in case the matter ends up before a judge. And I consult with our attorney and review with him any disciplinary action we're planning to take.

Sounds tidy, right? Problem is, shop-floor relations aren't. Things are often ambiguous at best. Last year, I had to grill a foreman about whether he had slapped a female employee on the rear, as she had alleged. His admission earned him a one-week suspension and a warning that he'd be fired for any more improper touching. So far, so good. But then a male employee complained that the woman in the case often put her arms around her male colleagues, in effect harassing them. This precipitated a staff meeting at which employees were told to keep their hands to themselves. The female complainant also faced withering criticism from several women who accused her of being unfair to the popular foreman. When she brought



her concerns about retaliation to management, we reminded everyone about our no-retaliation policy.

Sexual banter, common in many factories, can also make identifying harassment difficult. Earlier this year, a female employee came to me crying, insisting a male co-worker had threatened to rape her. The accused admitted, ashamed, that he had told the woman he'd like to rape her. "But," he protested, "I only did that after she suggested a three-way at the Super 8 Motel. I thought we were just kidding around." I reprimanded him anyway, and he got a warning slip. I also called the accuser back. Yes, she had suggested a ménage à trois. But only jokingly, she insisted. Welcome to the real world.

Kelly, a BUSINESS WEEK writer for nine years, is an officer at Emerald Packaging in Union City, Calif.



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'SEE YOU IN COURT— ER, MEDIATION'

Where to go to resolve disputes without litigation

It was the sum of \$5,000 that set off the dispute. Anthony Capetola, a restaurateur in New York City, was in a hurry to get to the courthouse. A judge was to hear his case, and he was determined to win. But Capetola, who is also a lawyer, had learned from his own case history: "It's often not worth going to a regular court because of the time involved."

But Capetola, who is also a lawyer, had learned from his own case history: "It's often not worth going to a regular court because of the time involved." But Capetola, who is also a lawyer, had learned from his own case history: "It's often not worth going to a regular court because of the time involved."

filing fee, and 90 days later, their case was heard. Within a week, the arbitrator found in Capetola's favor, awarding him the \$5,000 and allowing him to keep the \$5,000 deposit. His total out-of-pocket costs? About \$1,000.

Whether you're a small business, customer, employee, or partner, a small business can often solve its conflict more readily with ADR. It allows the parties to choose the date and place for the proceeding and, usually, to select a "neutral" (the industry's term for a mediator or arbitrator) who will handle the case. And often, ADR's nonadversarial tone lets you retain working relationships that otherwise would be shattered. It's a lot cheaper, too. While both sides usually bring attorneys along for consultation, legal and other fees are usually much

less than for a full-blown trial. An expert witness, for example, can submit a written report, rather than appear for a formal deposition and court testimony.

ADR comes in two flavors: arbitration and mediation. Arbitration is the more formal approach, in which a neutral, much like a judge, makes a ruling based on the facts presented by each side. Mediation is usually stipulated in a contract beforehand, along with who will administer the proceedings. Arbitration and mediation groups can recommend sample contract clauses.

With arbitration, decisions are final, binding, and, in general, almost impos-

WORK IT OUT: Avoid court, and you might avoid shattering otherwise profitable relationships

sible to appeal. In contrast, "mediation works best when both sides are willing to reach a settlement rather than win who was right or wrong. A mediator meets with all sides to set the stage, then privately counsels with each side until they can agree on a resolution." According to the AAA, mediation resulted in a settlement about 85% of the time.

FINDING COMMON GROUND. For example, George L. Bowen, senior vice-president at CNA Insurance Brokers & Agents in San Mateo, Calif., was in mediation with a client in a contract dispute when both sides took the case to court and hired a mediator to help them find a solution. Bowen says the mediation group, by the afternoon of the first day of mediation, the sides made the radical decision to terminate their lawyers. A mere 10 minutes later and a little less than \$10,000 into mediation, the case was solved. "We discovered common ground where we wouldn't have when our lawyers were up," says Bowen.

How much does ADR cost? With arbitration or mediation, you'll have to pay a neutral \$150 to \$200 an hour. A daylong mediation session will run, on average, about \$2,500. Arbitration cases last an average of three to four days, according to the AAA, which has an average cost of \$7,500. The charges are usually split between

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parties, along with a filing fee that can range from a few hundred dollars to a few thousand for a complex dispute.

If you're convinced alternative dispute resolution could work for you, how do you choose a neutral? With tens of thousands of arbitrators and mediators available nationwide through both nonprofit associations and for-profit firms, the challenge is finding one with the appropriate expertise in small-business disputes rather than, say, marital or neighbor-related cases. The easiest way to find one is to go through a national ADR provider with an assembled roster of neutrals (table). We took a careful look at the rules and procedures of these national firms, and surveyed their costs.

If you decide to choose the mediation route, you'll want to use a provider that allows you the flexibility to find a mediator with whom you can work effectively. It's often more efficient for a small business to hire a firm that provides administrative services. That means they'll give you advice on possible neutrals, not just hand you a list, and take over the scheduling and day-to-day coordinating responsibilities, which are best handled by an impartial party rather than one of the disputants. With these requirements, we had to drop the venerable AAA from consideration for mediation. Although it does administer cases, the AAA appoints mediators without giving the disputing parties a say in the matter. This can be a problem when adversaries aren't comfortable with just any neutral. (Although it's possible to modify these rules in the contract, we figured it's easier to work with procedures that build in choice.)

We also ruled out the Center for Public Resources' Institute for Dispute Resolution. Although CPR does administer cases, the think tank and association

generally advocates the do-it-yourself approach. It also tends to work with larger companies, with plenty of in-house resources, that just want access to its list of neutrals. In 1997, it administered just 130 cases.

Of the remaining providers, JAMS receives our nod. JAMS has 25 offices across the U.S., which gives you a decent chance of being able to use their facilities—a real plus if you're looking for a neutral location to hold your hearings. Also in its favor, the majority of JAMS mediators are full-time ADR professionals, who may be more skillful

registrar—1,500. Like many of the other major arbitration groups, Resolute lets the disputants predetermine maximum and minimum awards the arbitrator can set. Moreover, it's the one among the major firms that does stipulate that it can appoint an arbitrator if the parties can't agree on one.

Regardless of which mediation or arbitration provider you choose, look for one with a local case manager in your area. That's a good indicator that the firm has enough established, active neutrals on its list in a given region to justify setting up an office. To choose among

neutrals, talk to past clients for references. B. Bates Jr., a senior mediator in San Francisco who has handled over 2,500 cases, suggests asking for contact names from the mediator's last 10 cases, so the information is timely and the references aren't cherry-picked.

Particularly in the case of binding arbitration, you'll want someone who understands your situation well enough to render a verdict. Look at the number of cases the neutral has heard, particularly related to the expertise you're seeking. The firm should

be able to provide vitae on potential neutrals. Capetola, for one, prefers working with an arbitrator with a business background, not just a long legal résumé. "I try to stay away from arbitrators who are pure lawyers," he says.

Whether you choose the firm of arbitration or the gentler guise of a mediator, ADR might leave your adversary shaking hands rather than butting heads.

By Mie-Yun Lee, editorial director
BuyersZone (www.buyerszone.com),
Boston

For more about Alternative Dispute Resolution, visit enterprise.businessweek.com

Neutral Ground

COMPANY NAME/WEBSITE	ESTIMATED 1997 CASES MANAGED/ PHONE NO.	NO. OF ARBITRATORS/ MEDIATORS	STATES THAT HAVE ADMINISTRATIVE OFFICES
AMERICAN ARBITRATION ASSOCIATION www.adr.org	78,769 212 484-4000	18,000	Ariz., Calif., Colo., Conn., D.C., Fla., Ga., Ill., La., Mass., Mich., Minn., Mo., Nev., N.J., N.Y., N.C., Ohio, Pa., Tenn., Tex., Utah, Va., Wash.
CPR INSTITUTE FOR DISPUTE RESOLUTION www.cpradr.org	130 ¹ 212 949-6490	70	N.Y.
JAMS/ENDISPUTE www.jams-endispute.com	15,304 800 352-5267	396	Calif., Colo., D.C., Ga., Ill., Ind., Mass., N.J., N.Y., Ore., Tex., Wash.
NATIONAL ARBITRATION AND MEDIATION www.nationaladr.com	7,000 800 358-2550	900	Ill., Mass., N.Y., Pa., S.C., Tenn., Tex., Wis.
RESOLUTE SYSTEMS www.resolutesystems.com	12,000 800 776-6060	1,500	Ga., Iowa, Ill., N.Y., S.C., Tenn.
UNITED STATES ARBITRATION & MEDIATION ²	12,000 800 318-2700	631	Ala., Alaska, Ark., Calif., Fla., Hawaii, Idaho, Ill., Ind., Iowa, Kan., La., Mass., Mich., Minn., Miss., Mo., N.Y., N.D., Okla., Ore., Pa., S.D., Tex., Wash., Wis.

¹ Does not reflect cases handled, but not administered, by CPR arbitrators and mediators.

² USA&M website is currently under construction

DATA: BEACON RESEARCH GROUP INC.

and less distracted than part-timers.

If mediation won't do the trick, you'll need an arbitrator with sound decision-making capabilities. If possible, seek one who has experience in your type of case or industry. For the greatest choice, try the AAA, whose mammoth 18,000-person Rolodex counts former judges, active lawyers, corporate counsel, and businesspeople among its arbitrators. However, the AAA process has one major downside: The larger the disputed claim, the higher the filing fees.

If you can't abide the loss of control typically associated with arbitration, call Resolute Systems Inc. Next to the AAA, Resolute has the most neutrals in its

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Jared Schutz can't help himself: He starts companies. At 24, he has a BA from Princeton University, a coin collection, a few dogs—and a business track record that most 60-year-olds would envy. His first venture was trading government scrap metal, finding buyers for old shell casings and helmets. Sealed bids let the 16-year-old operate with no one the wiser. "It beat having a paper route," Schutz says. In 1994 those earnings provided his grubstake for Chicago-based American Information Systems Inc., a technical consulting firm he co-founded with two partners while still in college.

AIS's revenues are now more than \$5 million per year. In 1995, Schutz started up Stardot Consulting in Washington, to help politicians build Web sites. Last year, Daniel Cunningham, 23, tapped Schutz for help founding athletic-equipment dealer Sportscape.com. The two met at Princeton, where Schutz was "always flying off to his

A Green Thumb for Startups

JARED SCHUTZ, FOUNDER OF PROFLOWERS.COM

business in Chicago," and "juggling 20 things at once," recalls Cunningham.

Although he's not involved in day-to-day operations of Sportscape or AIS and recently sold Stardot, Schutz still travels a lot from his base in Boulder, Colo. Once a week, he

buzzes out to San Diego to check on his latest venture, Proflowers.com, an Internet retailer that shipped its first bouquets on Valentine's Day.

His partners describe Schutz as a classic idea man, one with a deep understanding of the Internet and first-rate skills in marketing and strategy. Bill Strauss, 40, an operations expert from ChipSoft Inc. brought in as Proflowers' president, notes that Schutz "is very good at admitting his own weaknesses." He says Proflowers has been growing 25% a month since late July. One thing is sure: This young florist is no late bloomer.

By Edith Upd

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Brad Parkinson

fight the cold war. Today, the GPS system also is used by businesses and consumers to time financial transactions down to the nanosecond, guide cars and boats, and help fly airplanes in stormy weather.

And now comes a problem just as GPS is starting to take flight in the consumer marketplace. Researcher Frost & Sullivan predicts sales will jump from \$1.6 billion last year to more than \$5 billion in 2001—if the GPS bug doesn't create havoc, that is. "One small programming and software glitch could turn off some people if it's not fixed in time," says Stephanie Moore, a GPS market analyst with Giga Information Group in Cambridge, Mass.

Trouble is, the GPS network uses a

unique time-keeping system that runs on a 1,024-week cycle, which ends in the final seconds of Aug. 21. Back in the 1970s, cost pressures and bandwidth limitations forced programmers designing the GPS system for the Air Force to limit the cycle to 1,024 weeks. That way, the software that kept the GPS calendar could be squeezed into a small block of code.

"ROLLOVER-DUMB." But now, some GPS users may have to pay the piper. When the current 1,024-week cycle ends, it's not clear how many of the estimated 3 million military and commercial GPS receivers will be able to handle the rollover. Receivers designed to accommodate the date—mostly those made after 1995—shouldn't be affected because their software was programmed to interpret the new cycle. But experts say many older commercial receivers are "rollover-dumb" and could suffer a range of problems from minor glitches in service to complete shutdowns. "It's another familiar story of computer en-

SOFTWARE

WARM-UP FOR THE Y2K GLITCH

GPS system needs its clock reset

Just when you thought you knew everything you needed to know about the dreaded year 2000 computer glitch, guess what? There's a lesser-known techno bug to worry about that could start vexing businesses and consumers as early as months from now.

The problem: Precisely 13 seconds after midnight on Saturday, Aug. 21,

1999, hundreds of thousands of satellite-aided time and navigational devices—gizmos used to help guide everything from the Pentagon's smart weapons to campers trekking through the outback—could suddenly go kaput.

What gives? Look to the heavens—to the military's Global Positioning System, a network of 24 satellites developed by the Air Force in the 1970s to

Information Technology

gineers designing these systems and failing to visualize or care much about what could happen years down the road," says Rich Bailey, a product manager for Datum Inc. in San Jose, a systems-timing manufacturer.

Businesses won't escape. Some companies have synchronized their computer networks to GPS time in order to record the exact second of a financial transaction. AT&T Corp., for example, says it aligns its core computer networks against GPS time because it improves the accuracy of time-stamping on critical financial transactions. Some worry that when the rollover occurs, receivers may start thinking it's Jan. 5, 1980—the date the current GPS period began. "If your system suddenly starts reading that a transaction was made Jan. 5, 1980, it might affect interest-rate calculations," says Ron Stearns, a GPS market analyst for Frost & Sullivan.

SIMPLE FIX. The good news is that the fix itself is pretty simple. Unlike the year 2000 problem, this one doesn't involve updating millions of lines of date-doomed computer code. Instead, it's a matter of determining whether your GPS receiver needs to be replaced—or upgraded with a software patch that will

"trick" the receiver into thinking the August rollover date will never come.

But getting the word out to all those who own or use receivers is proving tough. For the most part, big businesses and government agencies expect to have their systems upgraded by next summer. The Securities & Exchange Commission, for example, says most large financial-services firms will have already made fixes by then. AT&T says it has upgraded or replaced any receivers that could have been a problem. And Boeing Co. says it has the rollover problem under control. "We started testing for this back in 1994, and so we don't anticipate any problems," says Boeing spokesman Bob Smith.

But small companies and con-

sumers may be caught off guard. More over, experts say they might have trouble wading through all the products and manufacturers. More than 375 models of GPS receivers are on the commercial market from more than 60 makers. Charles Trimble, founder of Trimble Navigation Ltd., a Silicon Valley GPS receiver maker, says the task of addressing the commercial market is "next to im-

ANOTHER DATE TO REMEMBER

Global Positioning Satellite receivers could go haywire on Aug. 22, 1999.

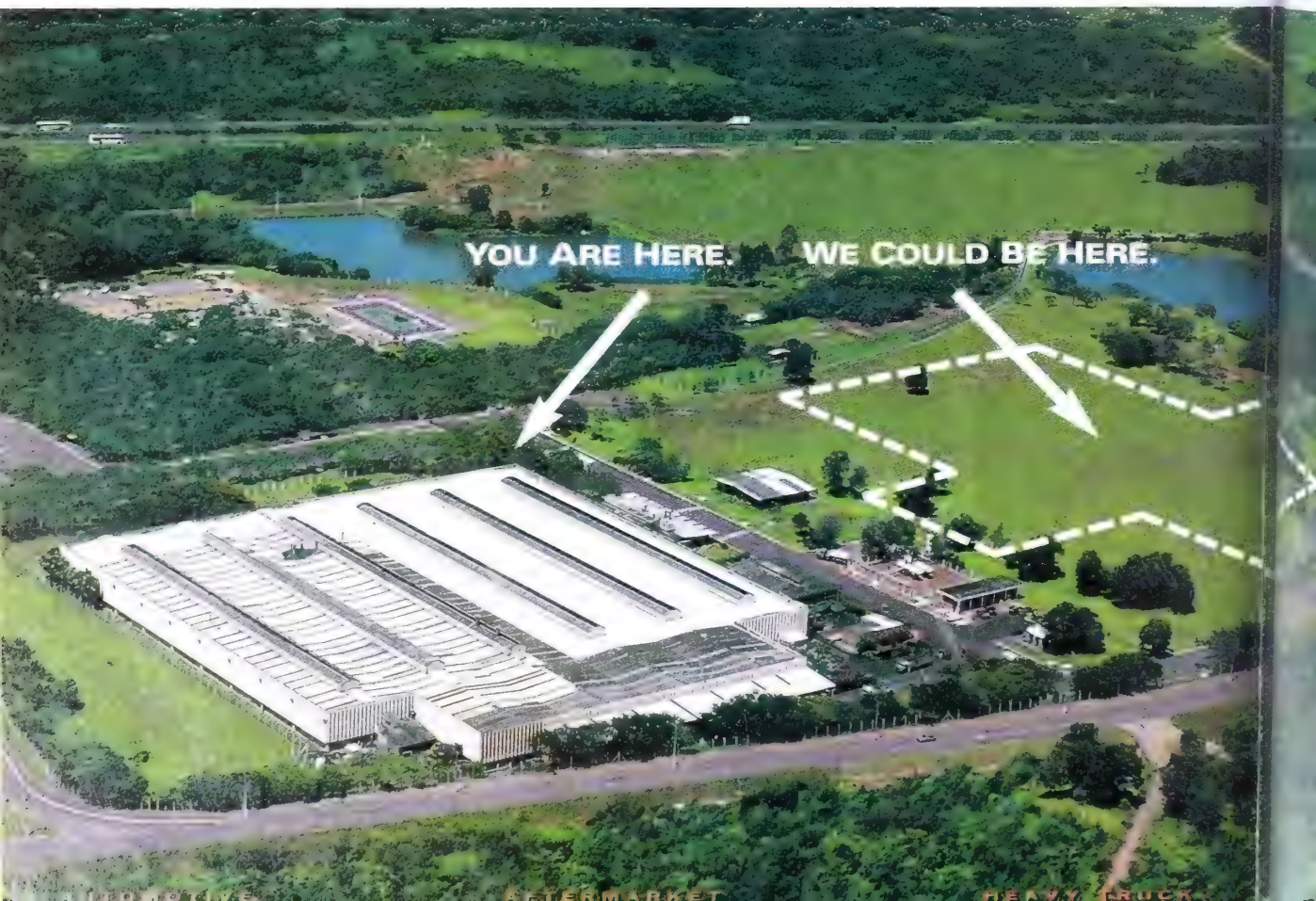
DATA: DATUM INC., DEFENSE DEPT., COMMERCE DEPT., FROST & SULLIVAN, GARMIN, UNIVERSITY OF TEXAS, AUSTIN, STANFORD UNIVERSITY

CONSUMER RECEIVERS

Navigational aids, including handheld GPS guides for hikers, onboard GPS boating and routing devices, and land systems for recreational aircraft.

WHAT COULD GO WRONG Devices emit erroneous data or shut down, leaving users to get lost or run into hazards.

THE FIX Contact the manufacturer. Some of them are offering free or discounted software fixes. Top makers of GPS consumer products include Magellan (www.mageilan.com), Trimble (www.trimble.com), and Garmin (www.garmin.com), which have information about the problem on Web sites.



possible. No manufacturer has an accurate or complete database of who owns these things or how they're using them." The Defense Dept. may also find itself in a bind. Although the Air Force assigned a GPS team to the problem, may not be able to make all the fixes in time. "We don't have a good sense of how many of the commercial receivers bought will be affected. It's not a majority, but there could be many, and those most prone to trouble could be fewer," says Aaron Reninger, a spokes-

man for the military's GPS program office in Los Angeles. The agency is upgrading receivers in the six GPS ground stations around the globe.

Defense's plans for all military aircraft to use GPS for navigation by 2000 and its growing dependence on GPS-guided smart bombs have heightened its concerns about the vulnerability of the aviation system. "People are depending on the GPS system far beyond anybody's expectations," Lieutenant Colonel Rick Reaser, chief engineer for the NAVSTAR

GPS Joint Program Office at Los Angeles Air Force Base, told a congressional panel looking into the rollover problem.

What to do? If you have a GPS receiver, contact the manufacturer. "Only the manufacturer will be able to figure out by testing which receiver will have problems and which won't," says Ed Parson, a GPS analyst with the U.S. Air Force's Space & Missile Systems Center in Los Angeles.

FREE UPGRADES. To help drum up awareness, both Trimble (www.trimble.com) and the U.S. Coast Guard (www.navcen.oscg.mil/systems) have created detailed Web sites outlining the problem. Trimble and other manufacturers also are offering customers free upgrades and some discounts on newer, glitch-free models.

But even if fixes are made, there's no guarantee of a glitch-free Aug. 22. "No one can say with complete certainty that we'll know what will happen on Aug. 22," says Trimble. Adds Bradford Parkinson, a Stanford University professor of aeronautics and a co-developer of the GPS program: "There's no way we can know everything at the time technology is developed. It's part of the complexity of the technological age." And, perhaps, a warning of its power.

By Marcia Stepanek in New York

COMMERCIAL RECEIVERS

Timing devices used to help synchronize factory equipment and enable financial transactions, coordinate digital capabilities, and handle land-navigational data for aircraft.

WHAT COULD GO WRONG Cell malfunction; financial transactions misdated, lost, or miscalculated; interest-income or payments; purchasing orders are based on 1980 data.

Determine whether these are dependent on GPS signals. Contact the manufacturer if the system needs upgrading.

UTILITIES RECEIVERS

Automated power systems that rely on GPS signals to synchronize power allotments to customers and that also help locate and fix power outages caused by storms or other sources of damage.

WHAT COULD GO WRONG Some generators could shut down or malfunction, causing temporary brownouts. Also, there might be delays in locating and repairing downed power lines.

THE FIX Public utility commissions are urging local power companies to determine whether their receivers depend on GPS technology and whether these systems need to be upgraded.



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COMMENTARY

By Amy Cortese

PORTALS: A GOLDEN DOOR FOR PC MAKERS

These days, it seems every company, from Amazon.com to Zapata, wants to be a portal, a general-purpose starting point—and, hopefully, sticking point—to the World Wide Web.

The latest victims of portalmania are PC manufacturers. On Sept. 23, Dell Computer Corp. announced a deal with Excite Inc. to create a custom version of the startup's Internet navigation site for Dell customers. Beginning this fall, when consumers buy one of Dell's Dimension PCs, they will be able to sign up for Internet access from AT&T or SBC Communications Inc. Then, using either a basic browser from Dell or Microsoft Corp.'s Internet Explorer, they will be ushered to a Web page co-branded by Dell and Excite.

Why? Dell has found that getting on the Internet is driving consumer PC purchases, and it wants to make the experience simple for customers. But there are deeper motivations. The fact is, there's a fundamental shift under way in personal computing. PC users are relying more on the Web to do basic tasks, whether calculating their investments or catching up on news. As they do, the PC and the software loaded on it are becoming merely the vehicles connecting them to a wide array of services on the Net. In short, the battleground has shifted from the physical desktop to the virtual space where people go to work and play.

FLEXING MUSCLES. And that's where PC makers see a glimmer of opportunity. Over the past several years, PC makers have been relegated to the role of distributor for Microsoft's software and Intel Corp.'s microprocessors. They have watched their margins erode even as Microsoft and Intel have grown fat off lush profits. Now, with the Internet, PC

makers see a chance to grab control of the customer relationship—and perhaps their destinies.

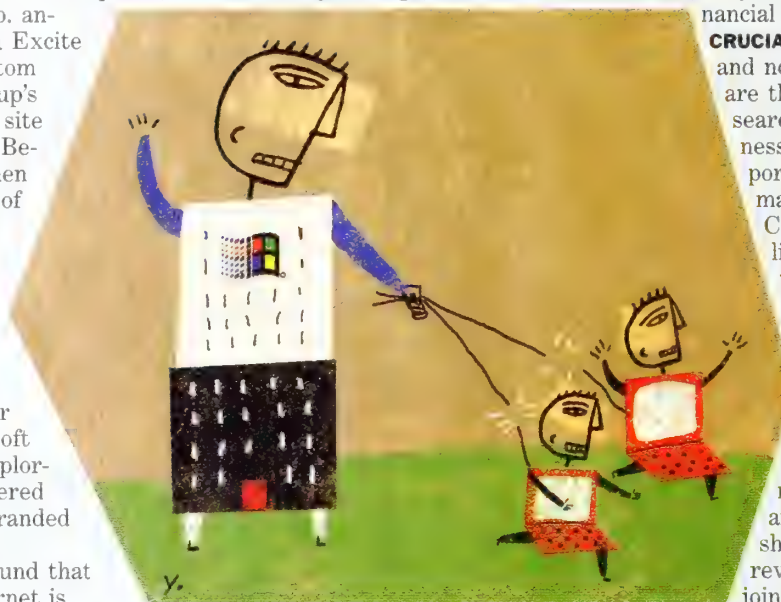
It doesn't hurt that Microsoft is embroiled in a landmark antitrust suit and has the Justice Dept. and 20 states watching its every move. Just two years ago, Microsoft

ney, has a distribution deal with Webtv. And Compaq is negotiating with potential partners to trade a stake in its Alta Vista search engine for Internet content or broadband Internet access. The planned portal "will be very important for our future," says Earl L. Mason, chief financial officer at Compaq.

CRUCIAL LINK. These deals—and no doubt more to come—are the latest twist in the search for a winning business model on the Net. For portal companies, big PC makers such as Dell and Compaq can steer millions of customers their way. For PC makers, portals suddenly look like a key revenue stream: Companies such as Excite and Infoseek pay millions for the privilege of being featured on a brand new PC, and then there are opportunities to share ad and transaction revenue generated on the joint sites. For profit-starved PC makers, "why throw that away?" asks Bruce Smith, Internet analyst at Jefferies & Co.

It's more than easy money, though. Indeed, the greater value in these portal deals may be the link they allow PC makers to build with their customers. By directing users to a custom home page, PC companies can keep their brand front and center and answer technical questions. And PC portals provide a valuable trove of customer data that they can use to market products. Dell, for example, figures that it can persuade many customers who sign up for its high-speed Net access to also upgrade to more powerful machines. Most of all, portals allow PC makers to differentiate their offerings—even innovate. For PC makers, portals might just be the starting point for new profits. But will they stick?

Software editor Cortese covers the industry for BUSINESS WEEK.



HERE'S THEIR CHANCE

With Microsoft embroiled in antitrust litigation, lucrative portals to the Net are fair game for the likes of Dell and Compaq

threatened to revoke Compaq Computer Corp.'s Windows license for merely offering Netscape Navigator alongside Internet Explorer, according to a deposition by a Compaq executive. Today, emboldened by the suit, PC makers are flexing their muscles before they atrophy. Let Microsoft have Windows. PC makers are realizing they can do an end run around the software giant by staking out their own cyberspace real estate.

Now, just about every PC maker is ginning up an Internet plan. The first was Gateway Inc., which in May created its own Internet service and portal, Gateway.net. Infoseek, which is now wed to Walt Dis-

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Zbigniew Czarnota, Research Engineer, Stockholm



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SILICON EYES

How chips that see will transform the way we live

At a Kroger's grocery store outside Houston, customers cashing paychecks must first put their fingers on an optical scanner at the service desk. The images are relayed to a personal computer, which compares them with fingerprints stored in a database—and flashes a yes or no decision within seconds. The price of the device, now about \$1,000, should fall to \$100 in a year or two. Since it was installed in February, it has eliminated check fraud.

The key to the price drop is a dramatically new kind of imaging chip. The

of strategic marketing at Texas Instruments Inc., which supplies components to Nokia. When cell-phone networks get the capacity to handle video data, the phones will be ready.

Another application for the new imaging chips is being explored at Donnelly Corp.'s research and development center in Holland, Mich. Tiny digital-video cameras using the new chips are being mounted on a van's side mirrors and back end to provide a sweeping, wide-angle rear view on a dashboard display. Such digital rearview "mirrors" could show up in cars in two to five years.

These new devices and many others like them are pointing to the next wave in the digital world: machines

with human-like senses. The long-term potential of sensory computers can be glimpsed today at Massachusetts Institute of Technology, where a robot named Cog watches its creators through silicon eyes as it juggles a Slinky. Cog keeps a watchful silicon eye on the researchers' comings and goings, because that's how it learns. Cog is being educated as if it were a child. And it is now so perceptive that the researchers often treat it like a human, says its maker, MIT computer scientist Rodney A. Brooks.

Cog's silicon eyes are made with special chips that process images as deftly as PC chips chew through spreadsheet and words. These new imaging chips with all of their applications, are creating "a huge new business opportunity," declares Donald M. Whiteside, head of Intel Corp.'s digital-imaging efforts.

"THE MIND GOES CRAZY." The imaging chips promise to transform the industrial landscape, the office, and the home. "The mind goes crazy thinking about all the ways these chips can be used," says R. John Fairholme, director of Motorola Inc.'s imaging-chip business. Cars could recognize when the front-seat passenger is a child and adjust air-bag deployment accordingly. Airplanes could have an army of chips standing watch over mechanical systems, from the landing gear to the fuselage joints and seams. And heart surgeons could leave tiny silicon eyes in a patient's chest to monitor their handiwork in the critical hours following an operation.

The hottest market at the moment is for digital cameras, which are already on the shelves. But impending applications will gobble up far more chips. "Cameras are just the tip of an iceberg," says David Escobar, director of digital imaging at Rockwell Semiconductor Systems Inc., which has been

Science & Technology

chips, just now arriving, are sparking a dizzying variety of applications.

In a Sony Corp. research laboratory in Silicon Valley, for example, scientists have developed the prototype of a pen-size digital camera that plugs into a cell phone. The combo can snap a photo of a newborn baby while the phone records the cooing between mother and child and then zip the multimedia package off to the grandparents in seconds. Finland's Nokia Group is also "pushing hard on putting an imager into a cell phone," says Douglas S. Rasor, vice-president



ing top-secret imaging chips for the military since the early 1990s. Now, its on spies are coming in from the cold, entering the commercial realm. Consultants at Cahner's In-Stat Group, based in Scottsdale, Ariz., see the imaging-chip market, including the products chips are used in, growing by 60% to \$23 billion in 2002, with a 300% increase in the number of products sold. In-Stat research director Mark Kirstein says that estimate is conservative. In any case, the market projections have prompted silicon heavyweights to pump hundreds of millions of dollars into imaging technology. In the U.S., Intel, IBM, and National Semiconductor are among the chipmakers racing to take out market positions. The competi-

tion includes NEC, Sony, and Toshiba in Japan and Philips Electronics and Siemens in Europe. There are also a bunch of ambitious newcomers, such as G-Link Technology Inc., Photobit, and Scotland's Vision Group, which shipped more imaging chips in 1997 than in its previous six years.

LIGHT INTO INFORMATION. The digital-imaging wave has built since 1969, when Bell Telephone Laboratories invented a new breed of chip—the so-called charge-coupled device, or CCD. These old-style imaging chips convert light into streams of digital information that can be used to assemble images. CCDs soon replaced the video tubes in yesteryear's bulky TV-studio cameras, paving the way for today's portable camcorders.

The next important development, which kicked off the consumer-products revolution, was another Bell Labs innovation in 1979: the digital signal-processing chip. DSPs are specialized chips designed to deal with the enormous digital content of pictures and sounds, which can choke ordinary computer chips. Texas Instruments Inc. believes so strongly in the future of sensory computers that it has sold off all of its other businesses to focus on DSP chips. "DSP spans everything from digital cameras and cell phones to PCs and consumer electronics—and more," says TI Chairman Thomas J. Engibous.

The most recent development, which is leading to the rapid drop in prices for imaging chips, occurred in 1996. That

SILICON EYES WILL SOON BE EVERYWHERE

CONSUMER PHOTOGRAPHY New "smart sensors" will automatically correct exposure and allow images to be edited, by cropping or reducing redeye, right on the camera.

COMPUTERS "Eyeball" digital cameras will be built into monitors for video mail or for verifying the user's identity. Keyboards with built-in fingerprint scanners will substitute for passwords.

HANDHELD GADGETS Small digital cameras will soon become common accessories for cellular telephones and personal digital assistants.

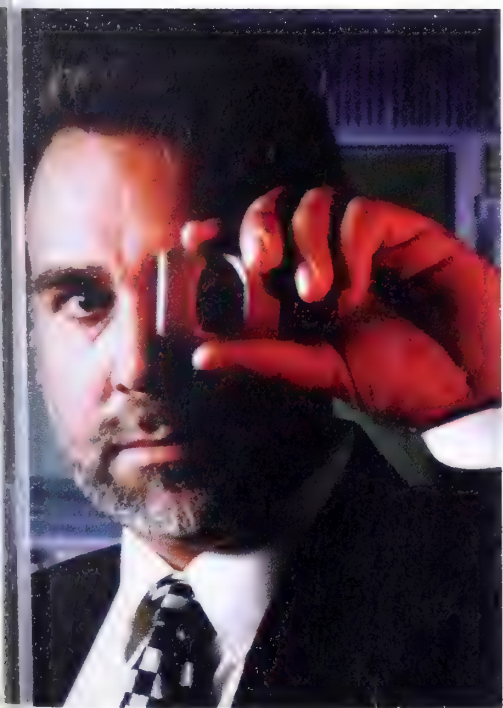
RETAILING Fingerprint and retinal scanners that can instantly verify someone's identity will be widely used by retail stores, banks, and government agencies.

MEDICINE Imaging chips may help blind people see and will be commonly used in surgery.

CARS Digital cameras will supplement rearview mirrors, check tire pressure, and monitor occupants as part of advanced safety systems.

INDUSTRY Among hundreds of possible applications, digital technology will sharply reduce the cost of sophisticated security systems and allow aircraft makers to monitor hard-to-reach places inside airframes.

VISION GROUP'S PETER DENYER PEERS THROUGH A DIGITAL CAMERA





Is your network, or your company, the same as it was two

On July 29, 1996, we introduced Microsoft® Windows NT® Server 4.0. The idea behind this server operating system, as with 3.51, 3.5 and 3.1 before it, was that customers would benefit from an OS that runs their network and their business applications. It was about integration, and it still is. But a lot has changed in two years.

To keep up with the changing needs of customers, we've added hundreds of enhancements since 1996. In fact, today's Windows NT Server 4.0 is far different from the one we first shipped. For starters, we've improved file and print performance, and updated Web and application services. We've also enhanced networking and communications services, and enabled streaming media. And, we're committed to continued improvement as we work to provide a solid migration path to Windows NT Server 5.0.

So how have these improvements been received? In just two years, about 640,000 U.S. companies have installed over 1 million copies.

A lot has changed in two years. Including Windows NT Server 4.0.



Windows NT
Server 4.0

[www.microsoft.com/go/](http://www.microsoft.com/go/WindowsNTServer)

Windows NT Server

Microsoft

Where do you want to go to?



CHECK IT OUT

Kroger's supermarkets in Houston are the first stores to scan fingerprints. The images are sent to a computer database, which can then authorize a customer's check within seconds

ing its focus to even faster digital imaging. Many experts say that digital photos from the better digital cameras, costing about \$700, match the quality of film snapshots—and digital cameras could soon be even cheaper than today's film models. That could make for a buying surge.

The dramatic reduction in prices has already led to a remarkable device—a credit-card-size \$50 camera for use in Nintendo's Game Boy, its portable video-game machine. The camera slips into the cartridge slot built to accommodate video-game cards. During its first month on the market in Japan, Nintendo sold 800,000 of the cameras.

By 2002, predicts market researcher International Data

Corp., filmless cameras will be running neck-and-neck with analog models. Digital sales will zoom more than tenfold, to 29.5 million units, says IDC. Nikon Inc., which unveiled its first digital camera for consumers last March, figures that IDC's projection could be conservative. Nancy Carr, national marketing manager for Nikon's new Electronic Imaging unit, says filmless models might overtake conventional cameras in five years.

Plummeting prices will make digital cameras a popular PC accessory in both homes and offices, IDC believes. Companies will install PC cameras to boost teamwork and facilitate collaborative projects that span departments or multiple geographic locations.

Videoconferencing will provide a cheap alternative to business travel, because eyeball cameras perched on computer monitors will soon cost no more than a computer mouse.

The "killer application" for digital cameras could be video mail. Today text-based E-mail dominates Internet traffic. Adding still or moving digital pictures could lift E-mail to new plateaus of popularity.

BRAINS, TOO. The new imaging chips are expected to grab 60% of the digital camera market by 2002, up from essentially zero last year, according to Canon's In-Stat. And they'll grab the lion's share of other markets for items linked to PCs. For example, semiconductor researchers expect low-cost imaging sensors to appear on keyboards and laptops as fingerprint readers or vision chips that can recognize faces. That will eliminate the need to remember passwords. In July, Compaq Computer Corp. unveiled a fingerprint reader that costs just \$50.

A further advance in imaging chips should occur next year: single-chip imaging systems. One piece of silicon will hold not only the silicon eye but also the brain it needs to process the signal—now on a separate DSP chip. Prices are expected to continue to fall. By the new millennium, semiconductor experts say, today's top-tier \$800 digital cameras may cost about \$300, while snapshot models could drop to \$100. And like PCs, upscale cameras will keep on dropping in price—by an average of 30% annually, says In-Stat.

Even digital optimists doubt the new technology

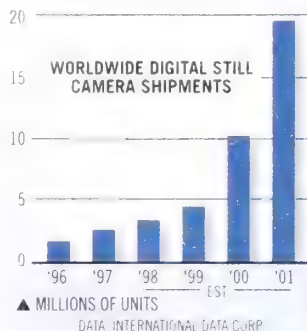
was the arrival of a new kind of imaging chip that uses CMOS technology. That stands for complementary metal-oxide semiconductor—it's the same technology used to make ordinary computer chips. The new imaging chips, then, can be made as cheaply as PC chips. The old-style imaging chips required costly, special-purpose production lines because they are custom made.

DIGITAL DELIGHT. Prices of chips that can capture images with more than one million picture elements, or pixels, have already dropped below \$40, says Peter Denyer, chief executive of the pioneering Vision Group PLC in Edinburgh, Scotland. The chips also use less battery power than the old-style imagers and produce the same image quality, Denyer says.

Many of the world's leading builders of electronic systems see digital imaging as the next big ticket to growth. That view is shared by makers of photographic film—notably Eastman Kodak Co.—and by camera companies. "There's not really a lot you can do nowadays to improve 35mm cameras," says Jeffrey L. Lengyel, marketing manager at Ricoh Corp.'s Consumer Products Group. "The excitement is focused on digital."

Even Polaroid Corp., which has built its empire on instant film, announced last spring that it is shift-

SAY CHEESE



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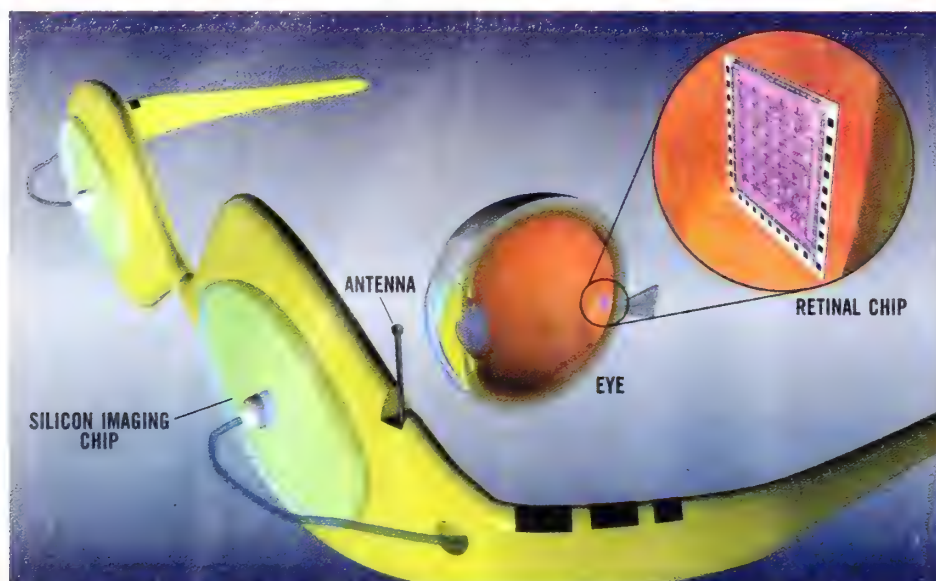
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CAN A CHIP CURE BLINDNESS?

In experiments begun last year, a camera on eyeglass frames sent images to an implanted chip. The blind patient could see a large letter

Wilder Eye Institute, a totally blind patient saw a large letter when data from a simulated imaging chip was wired to the retinal neurons of one eye. But questions remain. Can the technology provide sufficiently detailed vision to be useful? And will the body's immune system tolerate the silicon implant? Further research will be needed to answer those questions.

In the meantime, Intel is betting big on the future of the new imaging chips. The chip behemoth says it has spent hundreds of millions on digital imaging R&D in the past two years, and Chairman Andrew S. Grove says the investment "will be even more substantial as time goes on." Intel plans to use imaging chips to link cameras and other products to its Pentium microprocessors. "This is a potentially explosive opportunity," says Peter J. Green, general manager of Intel's digital peripherals division. **"UBIQUITOUS FEATURE."** Toshiba Corp. also hopes to capture a large share of the market. It is now one of the top suppliers of the old-style CCD chips, but it also plans a huge investment in new chips. Takeshi Enya, a Toshiba marketing manager, expects the market for both kinds of chips to grow rapidly but says the market for the new chips will grow faster. Of the 55 million imaging chips his company plans to sell in 2001, half will be of the new CMOS variety. Enya figures that the old-style chips will be used primarily in printers and scanners, while the new chips will prevail in mobile computers and digital cameras.

Bryan Ackland, a research manager at Lucent Technologies Inc.'s Bell Labs—where all this started—believes imaging chips are destined to follow the footsteps of digital clocks. Initially, digital clocks were costly stand-alone devices. Today, they're taken for granted on a range of products. Tomorrow, says Ackland, imaging chips will be a ubiquitous feature of everyday life.

A new chapter in the silicon saga is unfolding. Computers and other devices are getting silicon eyes. Everywhere you go, machines will be watching.

By Geoffrey Smith in Boston, in the bureau reports

close the shutter on conventional cameras within the next decade. Film is convenient and cheap, one-hour photo-finishing shops are everywhere, and old habits die hard. Still, Kodak Chairman George M. C. Fisher, whose company has perhaps the most to lose, acknowledges that there "will be an explosive market." So he's diving into digital imaging. The results are mixed so far; Kodak sells more digital still cameras than anyone but has yet to turn a profit on the technology. Fisher says, however, that he will continue the emphasis on digital cameras.

SEEING-EYE CIRCUITS. The arrival of the new chips has triggered frenzied efforts by makers of the old-style CCD chips to protect their turf. Despite the inherent manufacturing difficulties, suppliers have been improving resolution while cutting prices. "CCD makers realize that if they don't drop their prices fast, they'll be vulnerable," says William H. Boles, who until July was head of marketing at Olympus America Inc. Last year, 20 Taiwanese companies announced plans to make digital cameras. Ten dropped out before joining the fray. Even Sony, which makes the

world's best-selling digital camera—the \$500 Mavica—wonders whether the bloodletting is worth it. "We have to consider whether we should continue to put out new and better products if we have to lose money," says Shizuo Takashino, president of Sony Personal A&V Products Co.

The new imaging chips also have important applications in medical markets. Endoscopic surgical devices—thin tubes that enable a surgeon to see inside a patient—are fast being made disposable, in order to eliminate the need for sterilization. So manufacturers are switching from stainless steel to plastic tubes and replacing expensive old-style imaging chips with the cheaper new chips.

There's even a chance that digital imagers may serve as artificial retinas and help blind people see. Two decades ago, researchers showed that the brain's optical nerves can be electrically stimulated by optical sensors on a credit-card-size circuit board.

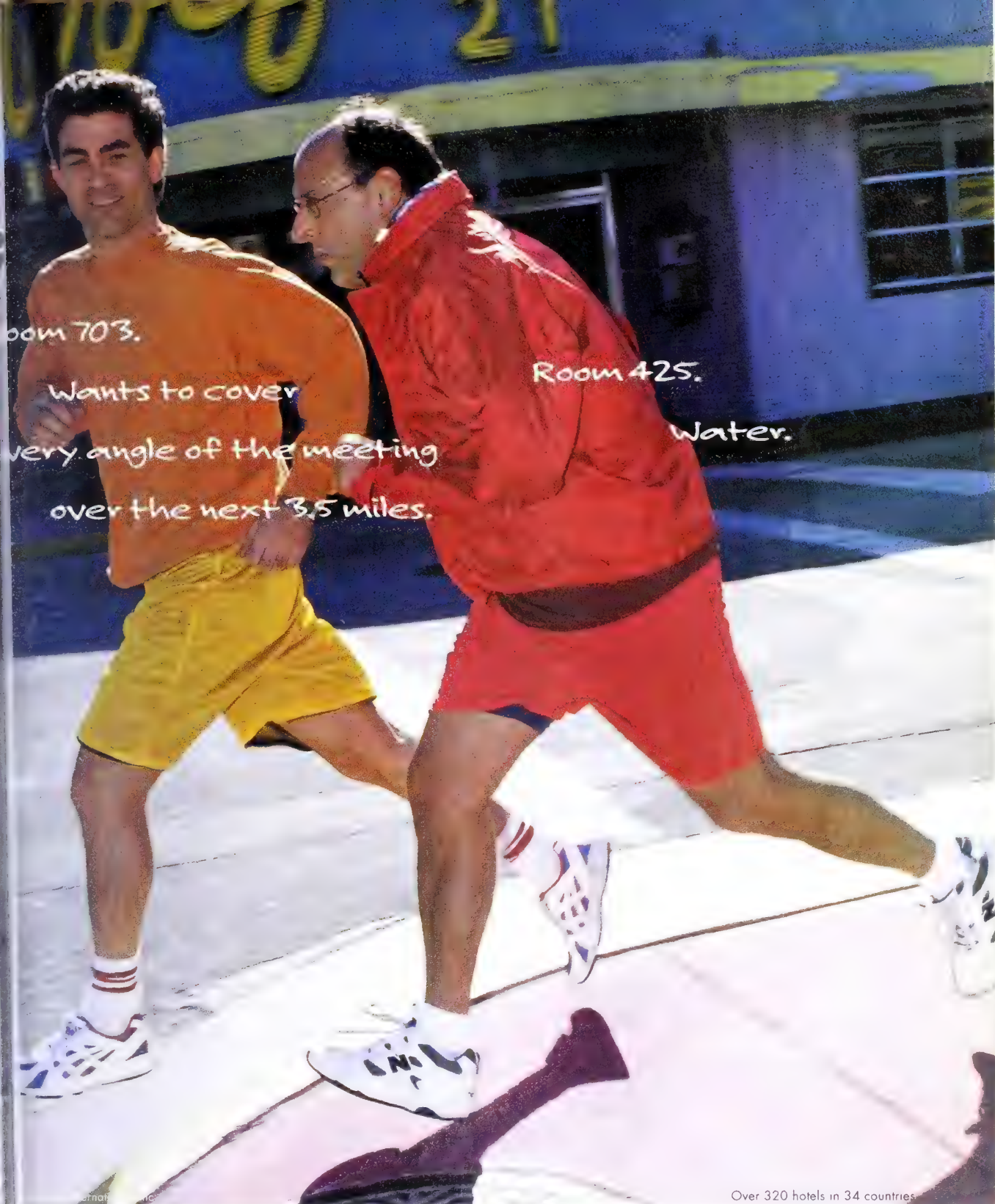
That enabled a blind person to discern very crude images. Given the advances in silicon technology since then, the National Eye Institute sponsored a study last year at Johns Hopkins University to explore the feasibility of implanting chips in or behind a person's eyes.

According to Dr. Mark S. Humayan of Johns Hopkins

CHEAPER CHIPS

Nintendo offers a \$50 camera option that slips into the cartridge slot in its Game Boy





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The New Math of Loss Prevention

GAB ROBINS' NEW ANALYTICS UNIT TURNS DATA INTO A PLANNING TOOL FOR RISK MANAGERS

For Gary Langsdale, corporate risk manager at International Paper's Memphis, Tenn. operational headquarters, data itself isn't important. What does matter is what he can do with it. Dealing with subsidiaries that include a wholesaler with a fleet of 6,000 trucks and 300 warehouse and store locations, Langsdale sees plenty of claims information. After all, accidents do happen. But

what Langsdale desires is to prevent incidents—such as trucks backing into parked cars, employees slipping in stores, and warehouse workers complaining of muscle stress—with information garnered from claims data. Says Langsdale, “we pay attention to claims data analysis because understanding claims trends can help reduce costs and prevent accidents.” And that’s where GAB Robins’ new Analytics unit comes in.

The experts at GAB Robins Analytics can take a company’s data—for example, trucking accidents—and ana-

lyze it according to type of injury, geography, job category, and many other fields of comparison. Then, Analytics can measure an individual corporation’s results against other businesses across the United States in the same ways that it analyzes a company’s own data.

Customized Solutions

“Our experts have years of significant claims data expertise,” says Rebecca West, vice-president of GAB Robins Risk Management Services. “They understand what the data is saying and can detect the more subtle patterns of claims.” West points out that the team members of Analytics have experience across a wide variety of insurance positions, including claims management, claims technology, claims account management, risk management, and loss control.

In addition, the Analytics unit uses innovative proprietary software and has developed partnerships with select, specialized resources to provide the latest, most sophisticated analysis capabilities.

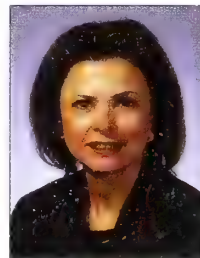
Thanks to this expertise, Analytics consulting services can really make a difference. The Analytics team creates individual, customized proposals for solutions to claims problems. Such analysis can also be very useful for risk managers seeking more precise estimates for setting aside reserves. “Reserving is a difficult and complex science,” says West. “You can apply formulas, but in the end you have to have knowledge of claims to do it well.”

Spreading the Word

One simple step Analytics usually recommends is publishing accident data in internal safety newsletters. It is an idea that IP has already taken to heart. “When you can tell the drivers their facility’s accident data, or show managers how

their unit stacks up against others in the same industry, they pay attention,” says IP’s Langsdale. “Our employees are competitive, and so they will work hard to make sure they have a better than average safety record.”

West says clients also use the data to create performance



Rebecca West,
Vice-President,
Risk Management
Services, GAB Robins
North America, Inc.

benchmarks, improve employee safety training, alter employee working environments, redesign incentive programs for loss control initiatives, and other programs. “When armed with accurate and comparative data,” says West, “you are in a better position to reward some employees for their safety records and show others how to improve their performance. You can give managers the training and workers the information they need to make a difference.”

Adds West, “you can significantly impact a company’s claims experience and resulting costs by looking into the patterns.” IP’s Langsdale concurs, saying, “the accident that didn’t happen is the least expensive one.”

Clara Van Hest, a New York-based writer, reports frequently on insurance and risk management.

Claims Analysis — How to Begin

- 1** Determine claim categories of greatest frequency or cost for your business such as back strain or auto accidents.
- 2** Look for patterns by geography, type location, type of job, type of equipment involved.
- 3** Distribute “best” and “worst” performance information to local management.
- 4** Create a benchmark of your business versus other businesses.

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Developments to Watch

EDITED BY CATHERINE ARNST

HAT DOES MARS SOUND LIKE?

REATHLINGS MAY BE able to eavesdrop on Mars via the Internet this year. If NASA's Mars Polar Lander chokes down without mishap in December, 1999, an audio chip on the vessel will pick up the first sounds on another planet and broadcast them back to Earth.

Nothing exotic is expected—just whooshing wind and scratch of sand blowing past the Lander. But there might be muted thunder and dust-cloud storms. "We don't really know what Mars's electrical discharges will be like," says Janet G. Luhmann, a physicist with Space Sciences Labora-



tory at the University of California at Berkeley. "It might be just a crackling sound."

The \$100,000 tab for the Mars Microphone project is being paid by the Planetary Society of Pasadena, Calif., a nationwide organization of space buffs. The audio chip is from Sensory Inc., and Advanced Micro Devices Inc. made the flash-memory chips

that will store the sounds. Martian sounds will be recorded in 10-second increments, and the loudest segment will be relayed back to Earth every 10 days.

Luhmann's team will post them on the Net at sprg.ssl.berkeley.edu/marismic, and they are hoping for something unexpected. That could secure a ride for another Mars eavesdropper on NASA's next mission in 2001.

Otis Port

HEARTENING NEWS ABOUT VITAMIN E —FOR MICE

HEALTH-FOOD STORES PROMOTE vitamin E as an effective weapon against heart disease, but there has been no proof that it actually works. Now, there's evidence it does in mice: Researchers at the University of Pennsylvania say they have shown that vitamin E protects mice against atherosclerosis, the artery-clogging condition that leads to heart attacks.

The mice were genetically engineered to have high cholesterol and develop atherosclerosis. The researchers reported in the October issue of *Nature Medicine* that, after 16 weeks, heart tissue damage was cut by 40% in the mice on vitamin E. Significantly, cholesterol remained high; the improvement seemed to come from a reduction of free radicals in the bloodstream.

Free radicals are constantly created in the blood. Scientists speculate that high levels of free radicals, caused by smoking or high cholesterol, can damage blood vessel walls. So-called antioxidants, including vitamin E, can mop up the excess free radicals—and perhaps prevent damage. But the idea couldn't be tested without an accurate method for measuring free radicals in the blood.

Dr. Garret A. Fitzgerald, chairman of the Pharmacology Dept. at Penn, says he and Joshua Rokach, a chemist at Florida Institute of Technology, devised a free radical test three years ago, enabling them to conduct the mouse trials. Fitzgerald cautions against taking large doses of vitamin E until human trials are conducted, but the American Heart Assn. does recommend eating foods high in vitamin E, such as lettuce. □

UDDLY—AND WITH AN ATTITUDE

ART TOYS DON'T NEED A LOT OF COMPUTER parts. Witness Furby, a garrulous and ingratiating new fuzzball that could be this Christmas' little Me Elmo. Like many other chip-enhanced dolls, Furbies talk, giggle, open and close their eyes, and respond to pokes, tilts, or tickles. But its latest electronic pet is amazingly convincing—in part because, like real pets and some family members, its reactions are a bit out of whack.

Furby's inventor, David M. Hampton, planned things that way. In the process, he saved Furby's manufacturer—Tiger Electronics Ltd., a unit of Hasbro Inc.—a bundle in manufacturing costs. To hold Furby's list price to \$30, less than one-third the cost of Microsoft Corp.'s ActiMates Barney doll, Hampton and the Tiger development team used some ingenious shortcuts. Instead of expensive communications circuits—the kind that permit wireless messaging among various computer devices—Furbies exchange crude infrared signals to trigger simultaneous-sounding giggles and goofing sessions. As for processors, the toy's silicon brain is a low-cost Asian variant of the chip that powered the original Apple II. Furby has trouble doing two things at once, and that's just fine, since carefully crafted software rules give the illusion of complexity. Talking, for example, always takes priority over listening. So Furby sometimes seems a little unresponsive—not unlike some children all know. Likewise, while the toy is in motion, its sound sensor automatically switches off, which saves battery power and prevents motor noise from confusing the sensor. Furby's 1,000 bits of trainable memory manage a vocabulary of just 200 words. But these words get combined in ways that even the inventor never predicted. The effect compares favorably with a hamster, and beats the heck out of a pet turtle.

Neil Gross



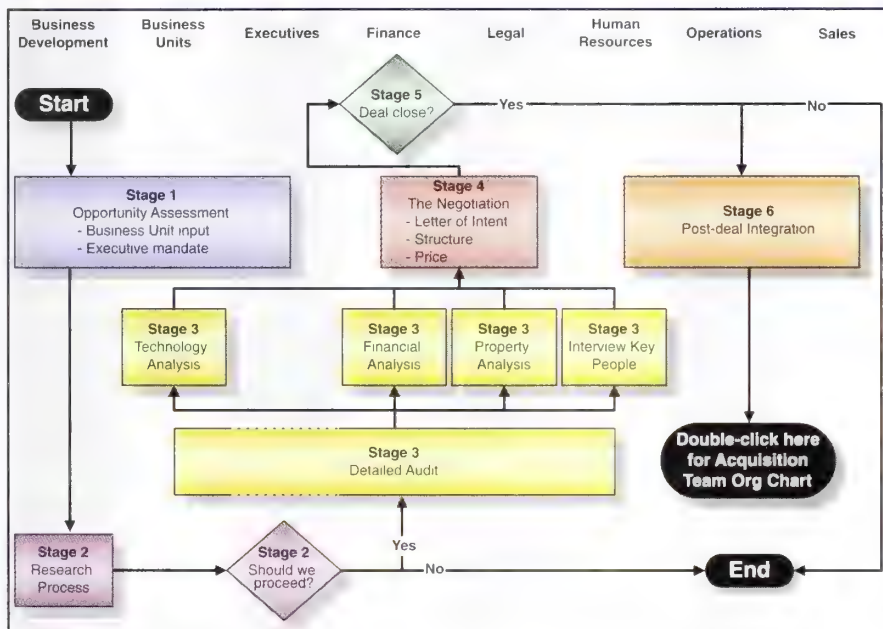
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COMMENTARY

By Brad Wolverton

HOW BOXING COULD GET OFF THE ROPES

It's a little past midnight in a dimly lit corner of the Georgia Dome, and boxing pooh-bah Don King is booming into a microphone about how he plans to make his "next \$100 million." His fighter on the Sept. 19 card, Evander Holyfield, has just managed to defend his twin heavyweight championship belts in a unanimous decision over a surprisingly strong challenge by a guy 25 pounds overweight, whose opponents' combined record is 181-511-19.

But even for a man who recently won a lawsuit in which he was accused of bilking Lloyd's of London of \$350,000 (nine jurors later went to the Bahamas on King's dime), who has beat an IRS tax-evasion rap, and who survived almost four years in prison for manslaughter, King's next \$100 million won't be a cakewalk. At least, not in boxing.

The fight game's most recent downward spiral began 15 months ago when Mike Tyson bit off two inches of Holyfield's right ear and was subsequently banned from the sport. If Tyson passes tests he has been undergoing to determine his mental stability, the Nevada Athletic Commission could reinstate him as early as Oct. 3. But even the return of a big box-office draw like Iron Mike might not be enough.

MISMATCHES. With the dearth of marquee fighters, cable TV has largely lost interest in boxing, and mismatches continue to be as common as comebacks. Traditional fight towns like Las Vegas and New York have significantly scaled back their events. And a Babel of sanctioning bodies has turned the sport into a Marx Brothers movie.

In June, a Holyfield title defense was canceled the day before the bout when challenger Henry Akinwande tested positive for Hepatitis B. Henry lost a \$2.5 million payday, but the promoters weren't weeping: Madison Square Garden had sold only 7,500 tickets, and a woman fighter on the undercard, Maria Nieves-Garcia, turned out to be 21 weeks pregnant.

With a market that wobbly, two of boxing's most ardent supporters, USA Network and ESPN, have in the past month dropped coverage of live weekly fights. USA replaced its 18-year string of weekly bouts with *La Femme Nikita*—a hitwoman in place of Hitman Hearn. ESPN, which was paying promoters around \$125,000 per event, now pays about \$60,000 for fewer fights on ESPN2. Says promoter

megafights generated an estimated \$203 million in revenue for the pay-per-view arms of Showtime and HBO. This year's only megafight—involving the sport's Great Hispanic Hope, Oscar de la Hoya—produced less than \$30 million.

It's hard to stir up excitement when promoters keep going for the sure thing by matching their fighters with patsies. Seth G. Abraham, president of Time Warner Sports, tried mightily to line up a legitimate heavyweight title bout between Holyfield and Lennox Lewis. But the fight, announced in June, was called off when Holyfield demanded an extra \$5 million.

"Don King is the Everest in front of us," Abraham says.

"He couldn't afford it if Holyfield were to lose."

OVERKILL. But what boxing needs more than legitimate fights is a clean, single sanctioning body. It simply doesn't mean as much to be a world champ anymore. Last year, some nine sanctioning bodies offered 201 world-title fights. Reducing the number of sanctioning bodies would bring some meaning back to title bouts and help eliminate mismatches. More important, making it easier to follow a boxer's rise might bring back old fans and win new ones.

Fortunately, boxing has allies in high places. Senator John McCain (R-Ariz.), a former amateur boxer, introduced the Muhammad Ali Boxing Reform Act in June. McCain says one reason he initiated the bill was a Don King contract with Oliver McCall stipulating that King would get \$2 million of the fighter's \$4 million purse, regardless of whether he promoted the fight. "There are egregious violations like this at all levels of the sport," McCain says. If passed, McCain's bill would help protect boxers and force sanctioning bodies to reform their rating systems. It surely wouldn't prevent King from making his next \$100 million. But he might have to do it the old-fashioned way.

Wolverton is based in Atlanta.



Cedric Kushner, who supplies fights to HBO: "Domestically, I'm seeing about 70% less revenue now."

Less TV time for boxing could make it difficult to develop the next generation of champions. In the 1970s, when boxers like Sugar Ray Leonard and George Foreman became household names, TV networks were running 50 fights a year. Now, the sport is relegated to premium cable channels like Showtime and Time Warner Inc.'s HBO. And despite an average audience of 2.7 million viewers for several recent big boxing events, premium cable has its limits. "We can't make stars like ABC can," concedes Jay G. Larkin, senior vice-president for Showtime Sports.

The absence of boxing's biggest star, Tyson, has certainly taken its toll on pay-per-view. In 1997, six



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Robert E. Rubin
Secretary of the Treasury

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Special Report

How to Reshape the World Financial System

The first and biggest task is to tame the anarchy of markets that globalization has unleashed

fear now is that a series of defaults would cause an unraveling of the global financial system, bringing international lending and borrowing to a halt. The tremors have even reached the U.S., with the collapse of giant hedge fund Long-Term Capital Management.

There is little argument that

today's global financial system needs to be rebuilt. The goals are obvious: Reducing the likelihood of future financial crises, preventing today's problems from spinning out of control, and restarting battered economies. At the same time, any fix needs to preserve and even strengthen the global flows of trade and foreign direct investment. These flows, which helped fuel the Asian miracle of the past 20 years, are the foundation for restoring growth in the future.

There is no perfect solution to the global mess—but BUSINESS WEEK believes there are ways to make things better. Some steps are easy: Everyone agrees that there needs to be better information and heightened regulation, both in developing and industrialized countries. But the far bigger task is to tame the anarchic nature of the global financial markets.

THE IMF OPTION. International finance is no longer the province of a relatively small number of large financial institutions. With the growth of rapid communications, investment banks, mutual funds, hedge funds, and multinational corporations all can jump in and out of markets at the click of a mouse. At the same time, financial wizards are creating swarms of new types of securities—ranging from derivatives to emerging-market debt—where the risks are hard to assess and price correctly.

Indeed, the current crisis stems, in part, from the breakdown of pricing discipline in global markets. Capital poured into emerging economies with little attention to the creditworthiness of the borrowers. As a result, countries like Thailand and Indonesia were able to borrow in dollars at far lower interest rates than they would be required to pay at home, encouraging them to take on far more

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and management of fiscal monetary policies provides guarantee against major economic crises."

—International Monetary Fund, September, 1998

It once was comforting to believe that the international financial system was a just and fair god. Countries that ran big budget deficits and borrowed from overseas to finance consumption, rather than investment, would be punished by capital flight and depreciating currencies. Nations pursuing prudent policies would be rewarded by strong growth and a steady stream of money from global investors. But when the world's top finance ministers and bankers gathered at the beginning of October in Washington for the annual meetings of the International Monetary Fund and the World Bank, they face a different reality. Despite being held for years by the IMF as models of development for the rest of the world, countries such as South Korea, Thailand, Malaysia, and Indonesia have been ravaged by capital flight. In the past decade, the IMF-led rescue plans for these nations do not appear to have worked. Unemployment and interest rates have soared, the value of their currencies has plummeted, and prosperity has turned into social dislocation and riots. The flow of funds into these countries has screeched to a halt. In Thailand, which has made impressive progress in modernizing its financial and legal systems, will not see a full recovery for years (page 120). Overall, the stricken Asian economies will shrink by more than 5% this year, according to forecasts by Standard & Poor's. In 1997, the average growth in Asia was 5.8%.

What's more, the rescue effort does not appear to have halted the rolling crisis, which has hit emerging markets such as Russia and Latin America. The victim: Brazil, whose stock market has dropped by almost 50% since mid-July as it battles the perception that its financial system, too, is becoming unsustainable (charts, page 114). The

foreign debt than they could handle.

When problems arose, everyone tried to get their money out as quickly as possible, making the crisis even worse. Complicating matters still more, there were no clear guidelines for which private-sector lenders had to share the cost of cleaning up the financial mess.

Not surprisingly, the road to restoring stability is not so clear. Economists and policymakers see three main alternatives for getting the global financial system under

Special Report

GLOBAL RISK

control. The first option would pump a lot more funds into the IMF—giving it enough resources to bail out troubled countries and get them back on their feet again. In effect, the IMF would be turned into a real lender of last resort for the world economy, much as the Federal Reserve serves as the last line of defense against the collapse of the U.S. financial system.

The danger of counting on the IMF, though, is the “moral hazard” problem. Assuming that they would be bailed out, investors would be encouraged to take bigger and bigger risks in emerging markets, leading to the possibility of even deeper financial crises in the future. Eventually, the crises would get so large that even a souped-up IMF could not handle them. Moreover, the IMF can never function as a true lender of last resort, since it will never have the Fed’s most potent weapon—the ability to print money.

FLOW VALVES. An alternative being given increasing consideration is the imposition of controls on international capital movements. The goal would be to damp down the tidal surges of “hot money” that helped overwhelm the emerging economies of Asia and Latin America. The notion is attractive to government leaders faced with a sinking economy. In Malaysia, for example, Prime Minister Mahathir Mohamad imposed an indefinite moratorium on capital outflows. But the idea of limited capital controls is picking up support among top economists as well. World Bank Chief Economist Joseph E. Stiglitz argues, for example, that it’s time to consider “some form of taxes, regulations, or restraints on international capital flows.”

Indeed, there is some evidence that capital controls can be effective in protecting an economy from the global markets. In 1991, for example, Chile imposed a 30% tax on incoming portfolio investments, refundable after a year, in an effort to slow money coursing in so fast it was creating an inflationary bubble. From 1991 to 1997, inflation declined from 22% to 6.1%,

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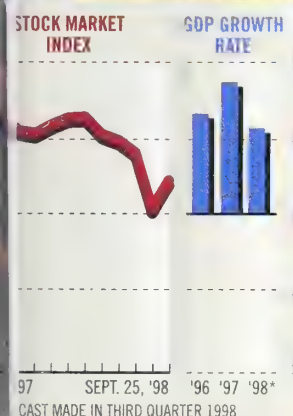
Nevertheless, the Chilean example cannot be counted on for complete success. Chilean businesses that needed funds went offshore in such great numbers that three-quarters of the trading in Chilean equities now occurs on the New York Stock Exchange. And many businesses have tried to circumvent the capital controls by smuggling, bribery, and false invoices. Indeed, Chile recently dismantled its belt-and-road controls in an effort to help the private sector get financing during the global market turmoil. “It’s paradoxical that many are advocating a [Chilean-style] system that has been repudiated by its very developers,” says Sebastian Edwards.

Financial crisis has depressed stock markets and growth worldwide

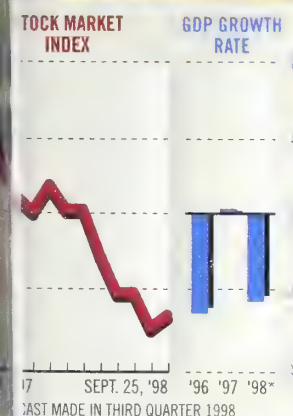
IL A trader watches stock values plummet in San Francisco



CO Uninsured workers in Tijuana: The shock



A In a Moscow market, a woman relies on international currency



investors—those people who provide long-term money—take the bath. Equity and bond investors get hit hard, but perversely, when the IMF comes in with a bailout package, much of the currency infusion actually goes to pay off the short-term foreign lenders who helped cause the problem. “If you had a bond in an Indonesian company, you got wiped out,” says Robert Litan, an economist at the Brookings Institution. “But if you made a foreign-currency loan to an Indonesian bank, you got off scot-free.”

What’s needed is gradually to change the rules to make all private-sector investors bear their fair share of the cost of a rescue effort, and not to favor providers of hot money. One proposal under consideration is a debt-restructuring plan akin to a Chapter 11 bankruptcy proceeding. Such a system, as outlined by proponents such as Harvard University professor Jeffrey D. Sachs, would allow a country in trouble to enjoy a temporary standstill on debt payments, with the approval of the IMF. Creditors and debtors would come to an agreement in an orderly manner on whether the debt should be marked down or exchanged for equity.

An approach like this could help revive moribund economies by providing what is in effect “debtor-in-possession” financing, giving special rights to those who provide credit after the original bankruptcy is declared. This would allow countries to tap new private capital, just as Chapter 11 in the U.S. allows bankrupt companies to get the credit they need to keep operating. The global equivalent would allow countries to get enough foreign exchange loans, guaranteed for a limited amount of time by the IMF, to allow exporters to keep functioning.

INCENTIVES. Formally bringing the private sector into the rescue process would cut the likelihood of future financial crises. Because lenders know they would not be bailed out by the IMF, they would have an incentive to pay closer attention to the quality

world Bank’s former chief economist for Latin America. Indeed, because of the acknowledged limitations to capital flows, economists and policymakers are searching for anyway to tame risk that won’t require countries to take a back from open capital markets. A big part of the problem is that there are no explicit rules for quickly resolving a crisis. The ad hoc approach worked in the past, but a debt crisis consisted of a handful of money-center banks lending to a government. Today, however, such crises involve thousands of banks, mutual funds, and hedge funds all lending to a slew of public and private debtors. Without a formal workout process, precisely the wrong

of their investments. They would also likely want higher returns on money invested in emerging countries. As a result, the existence of a bankruptcy option could moderate flows of destabilizing hot money to emerging markets.

When a financial crisis does occur, a borrowing country would be less likely to be crushed under the weight of its bad debts. Instead, the losses would be shared with institutions that made the loans originally, with the goal of getting the country back to economic health as soon as possible. This would reduce the chances of a spillover to other emerging countries. Moreover, if existing debt can be marked down or rolled over quickly, it becomes easier for a country

Rescue Plans: Weighing Some Options

There are some ideas on which just about everyone can agree. Emerging countries should supervise banks more closely and adopt more rigorous accounting standards. Better information should be gathered and disseminated about emerging-market debt. And Congress should provide the IMF funding that the Administration has requested. But there's a debate over more far-reaching efforts. Here are three proposals, with arguments pro and con.

BATTEN THE HATCHES Put controls on the flow of foreign capital to insulate emerging economies from global financial markets.

PROS Action may be focused on short-term capital flows rather than beneficial long-term investments. Controls can be reversed if they are no longer needed.

CONS Government intervention can choke off investment and growth. Government control of foreign exchange can encourage inefficiency and corruption.

MAN THE LIFEBOATS Strengthen the IMF's hand by pumping billions more into the Fund and turning it into a true lender of last resort.

PROS Resources would be available to defend embattled currencies. Troubled countries could get enough funds to get back on their feet again.

CONS Lining up funding would be difficult. The "moral hazard" problem, in which private lenders count on public bailouts, might create bigger future problems.

START OVER Codify debt rescheduling by allowing countries to petition the IMF to file for a debt-standstill agreement. This global Chapter 11 should spread risk and encourage more prudence.

PROS Borrowers are more likely to receive trade financing and could recover more quickly. Creditors would be more cautious, reducing the odds of future financial crises.

CONS The legal framework for a global Chapter 11 does not yet exist. Countries might petition the IMF for debt relief too readily.

DATA BUSINESS WEEK

that hit the skids to tap private capital markets again.

Of course, a global system modeled on Chapter 11 might not help every country with financial woes. Russia, for one, suffers from such severe internal problems that no fixes to the international system are likely to help. Japan, the linchpin of the Asian economy, is stuck in recession, unable to address its own enormous debt problems because of political paralysis.

Beyond that, some bankers object that allowing debtor countries to get out from under some of their obligations is a recipe for disaster. A Chapter 11 for nations is "the worst idea I've

heard in my life," says Paulo Ferraz, CEO of Banco Bozano Simonsen, one of Brazil's premier investment banks. "It would be the end of the global financial system."

"GET REAL." Moreover, many people are profoundly skeptical that such a proposal is anything more than an academic exercise. For one, unlike the U.S., the legal framework to compel creditors to accept a Chapter 11-type workout does not now exist on a global scale. In addition, some of the mechanisms that make Chapter 11 work in the U.S., such as the ability of creditors to shut down firms that are not economically viable, may not apply when the borrower is a sovereign nation. Even Treasury Secretary Robert E. Rubin, who thinks the notion is "a conceptually sound idea," admits to having doubts (page 126). "How you actually implement such a thing in an international regime where there is no Chapter 11 is a challenge," he says.

Nevertheless, the broad notion of moving toward a formal debt-restructuring system for the global economy is getting a great deal of attention these days. On Sept. 14, for example, President Clinton called for measures "to lift the weight of private-sector debt that has frozen the Asian economies." His urging followed the Bank for International Settlements' June suggestion that "the private sector [needs] to take some responsibility for the ongoing provision of credit to customers to

whom they had previously lent all too freely." The Group 22—consisting of the G-7 industrial countries plus 15 emerging economies—is also discussing new ways of dealing with private-sector debt.

In fact, history suggests that in times of crisis, demand for full repayment of debt can be an enormous mistake. After World War I, the victors' moves to collect war debts from Germany and reparations from Germany helped create the conditions that bred the Great Depression and World War II. In the 1980s, Latin America struggled for years under debt problems until a deal was struck allowing capital to flow in and grow to resume. By contrast, the U.S. system doesn't require companies or people who fall on hard times to spend the rest of their life paying debts back. "Once your old mistakes get big enough, they drown your future," says Elizabeth Warren, bankruptcy expert at the Harvard Law School. "Bankruptcy is a way to say to creditors, 'Get real. The money's not there.'"

Perhaps the hardest problem is how to decide when a debt standstill is appropriate. Clearly, it's important that a country not be able to unilaterally declare a debt moratorium—that's a sure route to chaos. Instead, the IMF should play the lead role in certifying when a country is in deep enough trouble to trigger the restructuring mechanism.

Both capital controls and a Chapter 11-type system have pluses and minuses. In the short run, capital controls are clearly an easier policy to adopt. Countries can implement them unilaterally, and they do not require new financing. In contrast, a formal debt-rescheduling scheme would be much harder to actually put into practice.

But capital controls do not solve the underlying problem of the world financial system. Rather, they are a temporary stopgap. A set of rules for global financial markets that simplifies the now messy process of debt rescheduling may be difficult to achieve any time soon. But in the long run, moving in the direction of a system that prices risk appropriately and keeps capital markets open is the right thing to do.

*By Michael J. Mandel in New York
Dean Foust in Washington, with bureau reports*

Special Report GLOBAL RISK



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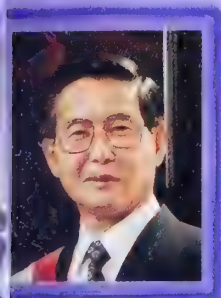
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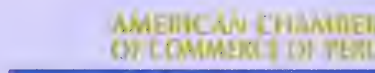
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BANGKOK

The question of reformers' minds: At what point will investors feel safe enough to roll in?

Cleaning Up Thailand's Mess: The Long Struggle Ahead

Until this year, Wisit Wisitsora-at had been waging a noble but thankless crusade. For more than a decade, Thailand's Justice Ministry had sought to overhaul the country's weak bankruptcy code to make it easier for creditors to extract payment from deadbeat corporate borrowers. Wisit, a former judge, was assigned to persuade skeptical Cabinet members and legislators to act. But since many lawmakers were also wealthy landowners who benefited from easy credit, few felt a sense of urgency.

Special Report

GLOBAL RISK

of Thai corporations in debt, the government of Prime Minister Chuan Leekpai is trying to push through sweeping bankruptcy reforms by yearend. Says Wisit: "Bankruptcy has never really been an issue in Thailand until now."

Nor, for that matter, have such issues ever been high on the agenda of the World Bank, the International Monetary Fund, or the Asian Development Bank. But now, these agencies realize that the global order faces a major threat: massive, rapid

Early results are impressive, but the makeover will take years to complete

flows of private capital to a few emerging nations as capable of managing. For developing nations has the sophisticated central banks, securities-industry oversight, and legal systems needed to cope with hot money—and clean up the mess when booms go bust.

So in January, the World Bank decided to help Thailand, Indonesia, and South Korea—all of which received IMF bailout—modernize their financial and legal institutions. With a budget of nearly \$60 million, the World Bank's new office for special financial operations now has a SWAT team of 24 staffers coordinating technical assistance on everything from drafting commercial laws to devising training programs for bank supervisors. "These are very complicated, long-term commitments," says Jonathan L. Fiechter, who heads the Washington-based unit. "These governments did not want people to fly for a few weeks, give cookbook advice, and then fly out."

As the first Asian bailout recipient last year, Thailand became the testing ground for this effort. This spring, some consultants were on the ground, from McKinsey & Co. structuring experts to central bankers from Japan, Germany, and Britain. The early results are impressive: While other Asian governments dawdle, Thailand already has shut down



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failed financial institutions and sold off most of their \$23 billion in loans at steep discounts to foreign investors. Authorities also have taken over weak banks or forced mergers on them, and are preparing to auction billions in bad loans. Thailand's securities regulators are more aggressively punishing insider trading and misuse of corporate funds.

While this is significant progress, the makeover of Thailand Inc. will still take years, if not generations, to achieve. Meanwhile, the effort is doing nothing to solve the country's immediate crisis: a devastating dearth of capital. Thailand's banking system is so paralyzed that even manufacturers with firm export orders can't get trade financing. And the once-booming stock market is deathly silent. With the economy expected to contract 20% over the next two years—and foreign banks and

Special Report

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portfolio managers now avoiding emerging markets—capital isn't likely to flood back soon.

To many local businesspeople, Washington's new obsession with modernizing institutions is like offering to install a high-tech sprinkler system after the barn has already burned down. "We need money to find a way out of these problems, not just bankruptcy courses," says Sarasin Viraphol, an executive vice-president for Thailand's giant Charoen Pokphand Group. Still, Thai officials agree that the reforms are overdue. The first step will be fixing the Bank of Thailand.

An inquiry into the central bank's oversight has found that examiners often couldn't verify the amount of bad loans or the quality of risk management at Thai institutions. If examiners knew of problems, the job of disciplining banks went to a separate policy department that was subject to political interference. The new system will combine the central bank's oversight operations into one office. The bank is also setting up a school staffed by foreign instructors to train more than 200 examiners in such areas as credit analysis, monitoring foreign-exchange transactions, and assessing bank management.

NO CAPITAL. Fixing Thailand's dysfunctional bankruptcy system, which favors the owners of companies, is another goal. Now, a borrower can tie up a case in court for as long as a decade. As a result, hundreds of Thai companies are stiffing creditors despite having assets to sell. One reason: Thailand lacks a procedure similar to America's Chapter 11, where debts of salvageable companies are frozen while they undergo court-supervised workouts. Instead, a company must liquidate

Overhauling Thailand's Financial System

BANK OVERSIGHT

Bank of Thailand examiners will be retrained by foreign instructors. A computerized payment system will help the central bank track offshore private debt. Thai banks will establish credit committees to approve loans. Loans will be listed as nonperforming when borrowers miss payments for three months.

BANKRUPTCY

Laws are being enacted making it easier for creditors to force insolvent borrowers into liquidation or to reorganize. A bankruptcy court is being established. Judges will be trained at a special school.

DEBT RESTRUCTURING

All but 23 of Thailand's 91 financial institutions have been shut. Foreigners may buy stakes in the survivors. The government is taking over and cleaning up weak banks. A new agency is securitizing billions of dollars in bad loans and selling them at discounts to foreigners.

DATA: BUSINESS WEEK

and its owners get wiped out. "People are afraid of bankruptcy," says Wisit. "We need to destigmatize it."

The new laws, bankruptcy court, and training institutions aim to address these problems. But politics remain an obstacle. Thailand's Senate watered down legislation in April that gave more rights to creditors, and getting a new law passed by Congress as planned will be difficult. There are also doubts about how well the system can adapt to the rule of law when disputes have traditionally been settled informally. "Changing the law doesn't mean attitudes will change overnight," says Kitiyaporn Urapeepatanapong, who heads U.S. law firm Baker & McKenzie's Bangkok office.

The bigger question is whether adopting the trappings of a Western financial system will convince investors that it is now safe to risk their money in Thailand. Consider the nation's stock exchange. Since last year's meltdown, the Securities and Exchange Commission has delisted dozens of companies and begun to prosecute rogue traders. A computerized trading system

can quickly detect irregularities. But foreign interest is so dead that most Western brokers have shut their research offices. Daily trading volumes of \$25 million, vs. nearly \$4 billion in 1997, are common. New issues are rare. "There is no capital market for Thailand," says Vallobhacholmolvanich, vice-chairman of TelecomAsia Corp., whose high-flying stock of the early '90s. "Why would investors come?"

The lack of foreign interest poses a risk to Thai reformers: How do they know their effort to upgrade financial institutions will satisfy investors as much as the IMF? "Everyone agrees the reforms are needed for the long run," says Amaret Sila-on, who heads the agency charged with reforming the financial system. "But what level do we have to reach for investors to be comfortable? Hong Kong's level? Japan's? America's? We don't know." Thailand can only hope that whenever Westerners catch emerging-market fever again, the country will be better prepared to handle the mayhem.

By Pete Engardio in Bangkok



HARD HIT

The country is still coping with a capital crunch



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U S W E B



China Builds a Wall— But Will It Hold?

As imports flow in and capital out, Beijing returns to protectionism

Chinese leaders had enough trouble plugging the dikes along the overflowing Yangtze River this summer. They may be fighting even bigger floods now. The Asian economic crisis is causing tidal waves of cheap imports to wash into China. At the same time, money is flowing out—\$20 billion last year, and probably much more in 1998. The two phenomena are related: Imports are putting pressure on Beijing to devalue the currency to make Chinese exports cheaper. And people and companies inside China that fear devaluation is inevitable are moving money out.

All this adds up to a massive challenge. Chinese officials are enacting protectionist

measures to stave off devaluation as long as possible. These include cracking down on unauthorized currency trading, supporting prices in such areas as steelmaking, petrochemicals, cars, and televisions, and erecting new barriers to imports and foreign investment that threaten local industries. The Chinese are gambling that good old-fashioned state controls can blunt the worst effects of global capitalism and keep the bulk of China's enormous savings inside the country. It's a very Chinese idea: wall yourself off from the world and rely on domestic demand and public works to pull you through. But this time it may prove impossible for a country whose huge export industries are so in synch with the global economy.

Already, the whispers in China's bazaars are that a devaluation of the yuan in 1999 is inevitable. In Beijing's silk market, the yuan is 8.9 to the dollar—7% less than the official rate—as

average Chinese convert their savings into dollars, smugglers buy up hard currency, and trading companies try to get their hands on foreign exchange. Beijing University economist Song Guoqing predicts an exchange rate of 12 yuan to the dollar by 2000. "It's a losing game. They can stop it," says Song.

But they can try to postpone it. In late September, the powerful State Council cracked down on unauthorized foreign exchange dealings. The mandarins want banks and companies to stop spiriting money out of the country and to repatriate overseas earnings rather than sock the money away in some foreign bank. Beijing announced that companies had until Oct. 1 to bring back the money or face punishment.

OPEN THE SPIGOTS. Meanwhile, the Chinese siphon off foreign reserves further by paying dollars for the smuggled oil, cars, and other goods and commodities flooding the country. The cheap imports are ruining business for local state-owned producers, which are struggling to unload

stockpiles of goods worth close to \$500 billion. Although authorities can't stop smuggling, they want to halt steep devaluing that might put weak companies out of business. China imposed "voluntary" minimum prices on 15 industries to blunt the impact of imports.

Of course, propping up Chinese industry means that state enterprise reform must be put on hold. Beijing is also encouraging banks to open the spigots. And it has shelved plans to clean up dud loans. "These days, no one is talking about bad debt," says Beijing University's Song.

Foreign companies are also getting pinched. China State Power Corp. intends to stop imports of small-scale power-generation equipment—a blow to General Electric Co. and Siemens. Provincial telecom operators must now buy locally made telecom equipment when possible, rather than imported stuff from Nortel, Lucent Technologies, and NEC. And an internal government circular in September suggested a ban on foreign participation in telecom services. Such participation is technically illegal, but until now authorities looked the other way while companies like Sprint, Siemens, and Deutsche Telekom skirted the rules. A ban would put millions of dollars of investment at risk.

Chinese authorities should beware of scaring off foreign investment at this crucial moment. Export growth is fading, domestic consumption is faltering, and ABN-Amro Asia in Shanghai forecasts economic growth a full point below Beijing's goal of 8% this year. With that target a minimum to keep absorbing new workers into the workforce, anything less means increasing ranks of unemployed. "China is not as attractive [for investment] as before," says ABN-Amro's Jim Lam. But China needs growth—and it needs the outside world to achieve it.

By Dexter Roberts in Beijing

Special Report GLOBAL RISK

CHINA'S PROBLEMS

CHEAP IMPORTS They are flooding in from other Asian countries, causing deflation

MULTINATIONALS They want to run telecom services and compete with local makers of power and phone equipment

CAPITAL FLIGHT Money is fleeing the country

AND ITS SOLUTIONS

PROTECTIONISM The authorities are imposing price floors for goods such as TVs, steel, etc.

NEW RED TAPE Beijing is restricting sales of such equipment, and may ban some telecom ventures

CONTROLS Regulators will vet all foreign exchange trades

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A Talk with Treasury Chief Rubin...

Financial storm clouds are swirling around the globe, but there's little sign of a crisis atmosphere inside the U.S. Treasury. Although the New York Federal Reserve Bank had just brokered a \$3.65 billion rescue for Long-Term Capital Management, Treasury Secretary Robert E. Rubin was his usual low-key self on Sept. 24 as he chatted with *BUSINESS WEEK* Editor-in-Chief Stephen B. Shepard, Washington Bureau Chief Lee Walczak, and Washington Senior News Editor Owen Ullmann, interrupting the interview only long enough to take a call from his wife, Judith. Some excerpts:

Q: What is the outlook for the U.S. economy in light of the global crisis?

A: The most likely scenario is solid growth and low inflation. But what has happened abroad has affected certain sectors significantly—for example, agriculture. The risk to our economy has increased as this financial instability spreads and the problems abroad have become greater. It is important to the U.S. that the international community continues everything that is sensible to try to minimize the damage. We in the U.S. need to continue to do everything possible to keep our economy growing, because that is very important to the health of the global economy. It is imperative that we get [International Monetary Fund] funding.

Q: Why was there a bailout of Long-Term Capital Management?

A: That wasn't a bailout. That was an agreement among [creditors] and Long-Term Capital Management, whereby the counterparties, in effect, bought 90% of what had been Long-Term Capital. What the Federal Reserve Bank of New York did was



...about Long-Term Capital, the IMF, Japan, Russia, and the President

to convene [a meeting]. The creditors made their own private-sector decisions.

Q: There's no government money?

A: There's no public money.

Q: In the wake of Long-Term's rescue, do you think there is a need for tighter regulation of hedge funds?

A: We have asked the Financial Markets Working Group, which includes all the regulators and is chaired by the Secretary of the Treasury, to look at this whole question of hedge funds and determine the implications of their activities so that people can make judgments [about regulations].

Q: Is there a case to be made for a tax cut to stimulate the economy?

A: A small tax cut provides very little fiscal expansion. But it has the possibility of creating concern in people's minds about whether we have a firm commitment to fiscal discipline. It's a slippery slope. At a time when there is so much financial instability in the world and so much

forces cutting against confidence, I think it's a mistake to do anything that could affect that confidence. That speaks to keeping our fiscal discipline—not having a tax cut.

Q: You and the President have tried to get Japan to stimulate its economy and fix its banks, yet all forms of pressure pretty much failed. What do you do now?

A: The world really is focused on this. All the talk is that growth in Japan is essential. I think that all any of us can do is try to be constructive in any way we can, in hopes that that can contribute to Japan doing what is in Japan's self-interest. The whole world is rooting for Japan.

That's the outlook for Russia?

Russia, obviously, has serious problems. The international community is very supportive of reform. Their government has to make a whole host of decisions about what policy they want to be on and how they deal with Russia's foreign debt. Unilateralism [in reneging on foreign debts] is not a path they should have taken.

The global crisis has given rise to new proposals for preventing future meltdowns. One is the creation of a global central bank that would be a lender of last resort. What do you think of that?

I think the problem that you have with the lender of last resort is, on the one hand, it can provide liquidity at a time of crisis, which is good. On the other hand, it raises "moral hazard" issues. You have to reconcile those two issues.

What do you think of the idea of a global "Chapter 11" process that gives countries time to do a workout?

For countries to participate in workouts on a regular basis seems to me a potentially sound idea. How to actually implement such a process in an international regime where there is no Chapter 11 is a challenge.

Do you see any place in the world for some kind of capital controls?

There are enormous drawbacks to capital controls that limit currency convertibility. You may get a short-term benefit in the very short but there are tremendous issues about workability, the effects of deterring international capital from flowing in. It can readjust the economy for doing things a country needs to do. Another [problem] is that if you look at the financial systems in a lot of these countries, they were very badly run. If you had better banking systems with better regulation, better credit cultures, and more skilled management that also would have created a stronger system.

Former Treasury Secretary

Baker says Congress shouldn't give the IMF the full amount of money you are seeking until it's completely overhauled. If Treasury Secretary is saying that, how are you going to get the money?

The whole system doesn't function the way it should in many respects, but that's not an IMF problem. It's a broad problem. But in the world that we live in right now, to deal with these problems, it's extremely important to get things done. I think ultimately that will prevail in the House, and it's a very substantial political challenge.

A number of executives say the Treasury may have been responding to the Asian crisis, and that some measures are a little too severe. Your response?

The first one, it's just factually wrong. In Thailand, what you had was a set of conditions that posed a real risk, as one that we were very much focused on and concerned about. As soon as a problem developed, we were

there. We made the judgment that the most effective way to work on that was through the IMF, which I think was correct. If you speak with the Thais today, they will say that we were a very powerful part of trying to deal with this from the beginning. The other thing that we recognized in Mexico [during the 1994-95 peso crisis] was the risk of contagion. There are people who said that I was exaggerating the risk. I always said there was a low probability, but there was a real risk of contagion. That's precisely what has happened.

It's interesting, as people line up, some say the IMF was too austere in trying to protect currency rates. There are other people who say that they weren't stringent enough and allowed devaluations. There are some people who say they should have focused solely on macroeconomics and shouldn't have focused on structural reforms. Then there were people who said they didn't focus enough on structural problems and were focused too much on macroeconomics. My own instinct is that they probably had it about right on monetary policy because you wanted to limit the collapse of the currencies. On fiscal policy, I think it's a closer call. Even if they were somewhat too stringent, on the whole they made good judgments in the face of unprecedented and extremely complex problems.



Q: *Given the President's difficulties with Republicans in Congress, are there hopes for a bipartisan approach to fixing Social Security pretty much dead now?*

A: I don't think they should be. Certainly, the President is fully committed to moving ahead with Social Security reform. I think Congress should be similarly committed.

Q: *Is the recent volatility in the stock market taking some of the steam out of the drive to invest part of Social Security in equities?*

A: I do think that the debate about investing in equities was being affected by the ebullience in the stock market. I think you'd probably have a more balanced discussion today. I have concerns about investment in equities.

Q: *You spend a lot of time with the President. People wonder how*

he is holding up. What is your observation?

A: I can't speak to how he relates to [the Lewinsky scandal] personally. I just don't know. All I can tell you is when dealing with the issues that I deal with him on—and I deal with a lot of issues—he's very effectively focused.

Q: *In light of rumors that you plan to leave soon, many businesspeople say they're not that concerned about the President's political future so long as Bob Rubin and Alan Greenspan stick around.*

A: I think that represents a fundamental misunderstanding of what has happened over the past six years. The President had a well-developed sense of what he wanted to do in office. He laid out the framework that we've had ever since. He has been the absolute leader of the economic team in this Administration. I think the best bulwark we've had in this Administration against nonsensical decisions is the President.

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HE WANTS TO RULE— AND HE SAYS SO

Charismatic Naoto Kan has Japan actually excited about an opposition leader

Naoto Kan has never been busier. He has been working 16-hour days, thrashing bank rescue acceptances to the Democratic Party of Japan, which he leads, and the ruling Liberal Democrats. Before the announcement of the bank rescue plan, Kan was on the campaign trail, engineering the party's stunning electoral victory in July. That upset ousted the LDP from gainstrol of the national assembly, the upper house and gave Kan the clout to negotiate the banks' fate with the Establishment. But with this exhausting schedule, Kan still finds time to study. The text he is reading over: *The Downing Street Years*, the memoirs of former British Prime Minister Margaret Thatcher. Says Kan's wife, "Yes, he'd like to be Minister."

His open ambition to lead is the political class's high state of excitement. The LDP has had to face an opening of any substance, decades it has only been absent from power for a brief period in 1993. Kan looks like the ideal article—a charismatic politician boldly pursuing a policy of painful reform but one who still commands huge popularity among voters. He has masterfully used negotia- tions to expose the LDP's waffles and inability to articulate a reform agenda. In short, he has a better chance than any outside politician of becoming the next Prime Minister. His bid might yet fail. But whatever

happens, Japan is finally hearing an alternative view to the LDP policies that have pushed the country to the brink.

The next peril Kan must face is the consequence of success. He and his aides originally wanted to block any bank plan by the LDP and quickly force a general election instead. "He still believes we

need an election to let voters decide who should carry out reform," says his wife. "But he has realized that voters want action on the economy first."

So in a quick change of strategy, Kan has hammered out a plan with the LDP, forcing the Liberal Democrats to agree to nationalize Long-Term Credit Bank of

Naoto Kan: A Life

1946 Born in the industrial city of Ube.

1965 Enters Tokyo Institute of Technology. Forms a study group to examine issues like pollution and U.S.-Japan relations.

1968 Leads a nonviolent student movement.

1970 Founds a consumer activist group.

1974 Manages the electoral campaign of feminist Fusae Ichikawa.

1977 Helps found the moderately left-wing Shaminren party.

1980 Wins a seat in the Diet's lower house.

1993 Helps launch the center-left New Party Sakigake.

1996 As Health Minister, exposes government's failure to halt the sale of HIV-tainted blood.

1996 Helps found the Democratic Party of Japan.

1998 Leads DPJ-dominated coalition to victory in the upper house.

DATA BUSINESSWEEK



So far, the public backs Kan's call for tough policies. "Kan has won the political lottery," says one backer

Japan, which is staggering towards insolvency. The LDP had wanted to ladle out cash to LTCB from a \$100 billion public fund, then merge it with Sumitomo Trust & Banking Co. But Kan has said no, arguing that a bailout with taxpayer money would perpetuate the system of sick banks that never quite die. With their backs to the wall, the LDP negotiators caved.

But now, Kan's young party needs to show the people that its "hard landing" plan actually works. If a number of sick banks slip into bankruptcy, now that Kan has signaled his opposition to public bailouts, voters might turn on the DPJ for triggering a meltdown. "We are quite anxious," admits Satsuki Eda, a DPJ member of the House of Councillors, the Diet's upper chamber. "We are sure it is necessary to rebuild our economy. But we are not sure our intentions will be understood." For now, though, it seems the public favors Kan's call for tough policies that force fast solutions. "Kan has won the political lottery," says Seiji Maehara, a DPJ member.

IRRITATING. Kan, who turns 52 in October, has waited a long time for stardom. A patent lawyer and physicist by training, he has always been committed to the political life. During campus riots in the late 1960s, Kan emerged as a leader of a nonviolent, moderately left-wing student front. He got his first taste of national politics in 1974 by managing the successful campaign of the late Fusae Ichikawa, a leading feminist and a vehement critic of corruption. Like Ichikawa, Kan regarded LDP Prime Minister Kakuei Tanaka, who perfected the art of money politics and was later convicted of bribery, as the country's chief villain.

Kan ran for public office three times before finally winning a seat in the lower house in 1980. A member of the tiny, leftist Shaminren party, Kan pounded the LDP leadership with questions on everything from health-care reform to nuclear power safety. That earned him the label *Ira Kan* for his irritating ways.

But it wasn't until 1993, when a fragile coalition bumped the scandal-ridden LDP out of power, that Kan came into his own. For two years, Kan played a central role in drafting policy, including increased funding for basic science research in universities. He rose to national fame in 1996, when as Health Minister he lifted the lid on the scandalous failure of his agency's bureaucrats to block the sale of untreated blood products, despite knowing of the risks of HIV contamination. Bureaucrats nicknamed him the Destroyer for his ruthless attacks. Since then, Kan has topped nearly every poll querying voters on their choice of Prime Minister.

While support droops for LDP Prime Minister Keizo Obuchi, Kan's popularity continues to grow. Kan and the DPJ want permanent tax cuts to stimulate consumer spending and draconian measures to clean up the bad bank debts that Kan estimates total some 20% of gross national product.

But the DPJ has

weakness. Kan still wants to engineer a general election, but his party as yet cannot match the LDP's organizational strengths, and it could fracture under pressure. The DPJ is called the "melting pot" party because its members hail from three different groups that merged to create Japan's second-largest political bloc. While it has agreed that taxpayer money should not prop up failing banks, members split on key issues, including the amendment of the U.S.-Japan Security Treaty. Moreover, the loyalty of DPJ insiders is not a sure thing. In briefings with the Japanese press, some DPJ politicians call Kan a dictator for single-handedly setting party strategy without consulting them. So Kan must watch out.

WIGGLE ROOM. The LDP may also struggle back. Obuchi has consented to use the opposition plan as a basis for legislation—but it has not been drafted yet. "The only thing we have agreed on is the temporary nationalization of LTCB," exclaims Yoshimi Watanabe, an LDP member of the lower house. "We have not settled the most important issues: how to build a financial system that

can avoid a crisis. We are supposed to draft this bill in a week." The LDP could still wiggle enough provisions into the bank bill to water down its reform elements and possibly discredit Kan's reputation as the scourge of the Establishment.

Kan also must watch his timing. He wants a general election as soon as his party has recruited enough candidates, ideally before the start of a special Diet session in November. For the moment, though, Kan can't criticize Obuchi openly, since that the Prime Minister has adopted the DPJ plan. Kan does not want to discredit Obuchi so badly that the LDP has to replace him with a less popular Prime Minister. In that case, Kan might face a tougher opponent, such as the feisty, opinionated Seiroku Kajiyama. If Kajiyama prevails over all these challenges, he'll be able to write a book even Maggie Thatcher could learn from.

By Emily Thornton
Irene M. Kunii in Tokyo

ON THE DEFENSIVE

To everyone's surprise, Obuchi caved in to Kan's demands on the banking rescue



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THE CEO, THE TOADY and the sycophant.

They stood around the table staring at a copy of *The Wall Street Journal* as if it emanated a fetid smell of sulfur. What happened? The CEO asked, pointing to the newspaper. We should be featured in that article. We're the leaders. I'm sick to my stomach from reading about them. Now they beat us on another proposal. A silence followed, deafening the darkened conference room except for the white noise of stale air circulating. How did they ¹(find the right people to pull it together so quickly)? Their designers are in San Diego. The finance group's in New York. Manufacturing's in Malaysia. Look people, we've got to get our teams to ²(collaborate better, faster). As Pogo said, I have seen the enemy and he is us. Is it their network? Their systems? We just don't have the ³(advanced technology), the Product Manager said. Well, get the people. Get the ⁴(tools). And get it done. The sycophant's eyes brightened. He raised his nose slightly, as if he smelled blood, opportunity or both. I think you're absolutely right, sir, he said, I've felt this way for at least six months now.

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WELL, MAYBE ALCATEL ISN'T 'THE LUCENT OF EUROPE'

Serge Tchuruk's dandy turnaround hits a wall, and now the company is being peppered with lawsuits

It's lunchtime at the New York Palace Hotel, and there isn't enough chicken to feed the standing-room crowd of analysts gathered to hear from Alcatel Chairman Serge Tchuruk. The stately Frenchman's \$22.2 billion telecom-equipment company was until lately the toast of Wall Street. Now he's explaining what led to a shocking earnings warning four days earlier, on Sept. 17, which triggered a 40% collapse in Alcatel stock price and rattled markets across Europe. Fluent in English, Tchuruk gamely tackles questions on strategy and promises that a big stock buyback is in the works. But when questioning touches on when he learned about the profit shortfall, Tchuruk, following the advice of counsel, clams up.

That information is the key to lawsuits filed since Alcatel's stock tumbled. The legal challenge comes from shareholders in DSC Communications Corp., a Texas company acquired for \$3.3 billion in Alcatel stock on Sept. 4. They claim that Alcatel held off the bad news until after the takeover was completed—a charge Alcatel denies. "Even if everyone in France takes off the whole month of August, who are they trying to kid?" asks Lee Squitieri, of Abbey, Gardy & Squitieri, a New York firm filing one of the suits. If Alcatel had fessed up earlier, shareholders say, it would have scotched the deal or at least led to a renegotiation. As it was, the stock Alcatel paid for DSC crashed just as the certificates were arriving in the mail.

MADDENING. Suddenly, the high-flying Alcatel has encountered turbulence. Competitors, such as Northern Telecom, are also experiencing a slowdown in orders. But in an industry rife with takeovers, Alcatel's reduced market cap drops it from the class of hunters to potential prey. And even if the lawsuits amount to nothing more than a distract-

tion, as industry insiders now predict, it's one that Alcatel can ill afford as it jousts with some of the world's fiercest tech companies, including Cisco Systems Inc. and Nokia Corp., to build the bandwidth for the Information Age.

This has to be infuriating for Tchuruk, 60, a former oil industry executive who has engineered quite a turnaround at Alcatel. Tchuruk, who declined to be interviewed for this story, arrived at the company in 1995, just as it registered a record-setting \$4.2 billion loss. He proceeded to shut down 60 plants at a cost of 30,000 jobs. He sold off unrelated divisions, from vineyards to magazines, all the while positioning Alcatel for the *fin-de-siècle* telecom battles.

By last spring, it appeared that Tchuruk had the pieces in place to pull off his strategy. His restructuring had produced operating profits topping \$1 billion in 1997. Telecom margins, at 4% still only half of rival L. M. Ericsson's, would rise, he assured analysts. And Alcatel, with its blue-chip customers eager to jump into the Internet, appeared ideally positioned. Analysts were calling it "the Lucent of Europe."

Hungry for results like those of Lucent Technologies Inc., investors on both sides of the Atlantic bid up Alcatel stock, nearly doubling it in the first half of the year. In fact, Tchuruk

TCHURUK
Did Alcatel hold back bad news till a deal closed?



have it all together. Not quite. With the telecommunications industry moving from traditional voice lines, Alcatel, to high-speed networks, he relied on a far larger presence in the U.S., the company's most advanced market and to most Net technology. With his rich experience along with the proceeds from the \$1.8 billion spin-off of Alcatel's main division, Tchuruk had plenty of money to spend.

ACQUISITION. He saw what he needed only five miles from Alcatel's headquarters in the Dallas suburb of Irving. It was DSC Communications, a long-old-line telecom supplier. DSC had little of the Internet glitz that Tchuruk was missing. But the company offered a large installed base. This was important, because servicing existing customers, with upgrades and new software, is a higher-margin business than installing new lines and equipment. "We were buying a business in the States," says Peter Tchuruk, Alcatel's vice-president for business development. On June 4, Alcatel announced the acquisition of DSC.

Since then, the newly deregulated European markets that were expected to pour money into Alcatel's coffers have instead dealt it a bruising. It was Alcatel's apparent inability to gauge the velocity of these changes, and respond quickly to them, that halved the value of its stock—leading



FIBER OPTICS

The industry is fast moving from voice lines, Alcatel's forte, to speedy data nets

from a buy to neutral.

Although Alcatel is now cheaper for a suit-or, it may also be less appealing. When asked at the September analysts meeting if Alcatel could be a target of Lucent, Tchuruk admitted that he had read that Lucent had its eyes on

DSC investors to call their lawyers.

The trouble, Tchuruk explained as he issued the profit warning in Paris on Sept. 17, is that Europe's biggest customers, such as Deutsche Telekom and France Télécom, no longer plan upgrades years in advance. They make decisions far more quickly, basing them on competition and with an eye to quarterly results. "The cycles seem to be collapsing," says Krish Prabhu, CEO of Alcatel U.S.A. What's more, many of them are now waiting to see which Internet technologies take root. The upshot: Alcatel's key customers cut back orders last summer by as much as 37%.

The question is why it took Alcatel so long to advise shareholders of the drop in orders and profits. According to Tchuruk's statements immediately following the Sept. 17 announcement and before the suits were filed, he didn't learn about the disappointing numbers until Sept. 8—after the DSC deal was done. If true, perhaps his frantic work to restructure Alcatel's businesses led him to scrimp on client contacts and internal communications. "It makes you wonder if they let relationships slip," says a London analyst who has downgraded the stock

Siemens and Nokia, as well as Alcatel. "All I can say is, 'Bon appetit,'" he joked. Analysts, though, think it more likely that Lucent would hunt for a networks company such as Ascend Communications rather than its old-line counterpart in France.

COOL GIZMOS. Alcatel officials stress that despite the market gyrations, the company still registered a 33% rise in first-half operating profit, on sales growth of 6%—strong figures, though lower than expectations. Further, the company boasts a slew of exciting products. Its Web-surfing screen phone is undergoing customer testing in Europe and may be released soon in the U.S. Its superfast cable connections, which could replace modems, should be installed in Compaq Computer Corp. personal computers within months.

And sharp new designs have lifted the company's cellular phones, long laggards, ahead of Siemens and Philips Electronics products, and they are now edging into the black. But even if profits spike up, count on Tchuruk not to boast for a while. He has seen how badly investors react to earnings whiplash.

By Stephen Baker in Paris

BEHIND ALCATEL'S TUMBLE

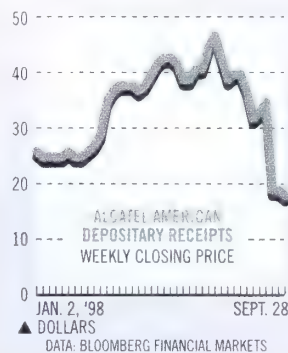
JAN. 1998 Alcatel stock takes off, nearly doubling in six months as analysts dub the restructured French giant "the Lucent of Europe"

JUNE Benefiting from the high price, Alcatel offers to acquire DSC Communications of Texas through a stock swap

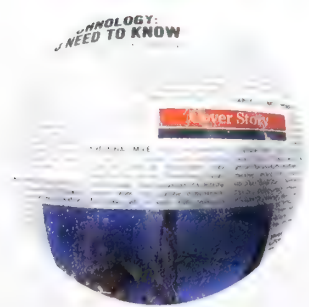
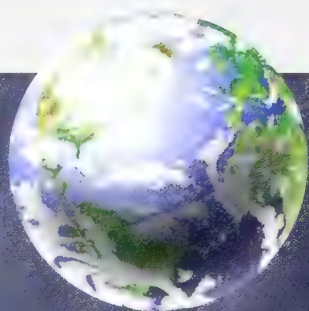
JULY-AUG. Alcatel's leading customers in Europe, waiting for next Internet technology, cut back dramatically on switch and wire orders

SEPT. 17 Two weeks after the DSC deal goes through, Alcatel issues a profit warning, causing its stock to tumble 40%

LATE SEPT. DSC shareholders file lawsuits, alleging that Alcatel hid disappointing numbers until the deal was closed



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COMMENTARY

By Karen Lowry Miller

A SECRET WEAPON FOR GERMAN REFORM

The victory of Social Democrat Gerhard Schröder in Germany has some executives and investors, both at home and abroad, deeply alarmed. All along, they feared that a left-leaning government would be even less friendly to business than Chancellor Helmut Kohl's administration, which failed to lower sky-high taxes and labor costs. Now they worry that Schröder and his likely coalition partners in the environmentalist Green Party will crush any hope of real economic reform.

But Schröder's team may find itself facing an odd business adversary, a kind of Trojan Horse within German walls that could be a huge catalyst for change. DaimlerChrysler, the new German-American company, has U.S. shareholders and managers who aren't likely to take threats to their company's competitiveness lying down. The auto giant is sure to keep up the pressure on Bonn for tax and other reforms. And other German companies will be watching closely for cues on how to lower costs, operate more efficiently, and motivate managers.

The sheer bulk of the \$130 billion merged carmaker—the world's fifth largest—will give it enormous clout. With its \$90 billion market capitalization, DaimlerChrysler will account for nearly 13% of the DAX index of 30 German blue-chip stocks. Thus, it will be a benchmark for investors scanning German shares. It already has an advantage, with higher margins and a price-earnings ratio of just 13 on estimated 1999 earnings, vs. 19 for the DAX. Other German blue chips will be under pressure to improve profitability or risk losing investment to the more attractively valued giant.

As Europe's biggest industrial company outside the oil industry, DaimlerChrysler will have lots of weight to throw at Schröder's policy-



makers. Its ultimate weapon is the threat of relocating its headquarters to the U.S. should Germany's business climate remain hostile. The auto maker can also wield its power in the form of capital investment. If labor and taxes remain prohibitively expensive, DaimlerChrysler will build plants elsewhere—or perhaps close facilities in Germany.

PAY WATCH. Corporate boards across Germany are already monitoring just how far Daimler Benz Chief Executive Jürgen E. Schrempp will go in Americanizing the Stuttgart-based company. The most visible disparity is executive pay. Chrysler Corp. CEO Robert J. Eaton and Schrempp will co-chair the new company for three years, when Schrempp will take over. Eaton makes more than eight times as much as Schrempp does. But Daimler supervisory board chairman Hilmar Kopper has made it clear that Eaton's total compensation—\$10.9 million in 1997—won't be matched.

Meanwhile, for its 1,600 upper level managers, DaimlerChrysler is setting up a performance-related pay scale unlike anything seen in Europe, Schrempp claims. Base pay will be lower than Germans are used to, with more variables such as stock options. The new packages will include another U.S. import: phantom

shares, which track the market price and are paid out when earnings targets are met. That could help forge a German management class that is more vociferous in demanding lower taxes.

The ground is already fertile. Daimler set a trend in 1993 as the first German company to list its shares in the U.S. The new DaimlerChrysler will have even more reason to keep shareholders happy. Some 53% of its shareholders are American, and over two-thirds of its cars and light trucks are sold in the U.S. As Daimler absorbs the American giant, "DaimlerChrysler will influence how German companies are managed," says German

consultant Roland Berger.

DaimlerChrysler could also help bring down German wage costs and ease work rules without any policy changes from Bonn. The merged company will continue to include a works council in its decision-making—a structure mandated by German law. That means DaimlerChrysler's labor representatives, too, will be more attentive to U.S. attitudes. Watch for more contract talk allowing flexible labor rules, and changes in the tone of industrywide collective bargaining in Germany.

Daimler won't be all-American, of course. Key elements of German corporate culture will remain, including the two-tiered system of a supervisory and a management board. But Corporate Germany and Schröder had better keep their eyes on Stuttgart. It may turn out that what's good for DaimlerChrysler is good for Germany.

Correspondent Lowry Miller covers German corporate strategy.

TEAMING UP

Schrempp, Eaton, and shareholders won't take threats to competitiveness lying down

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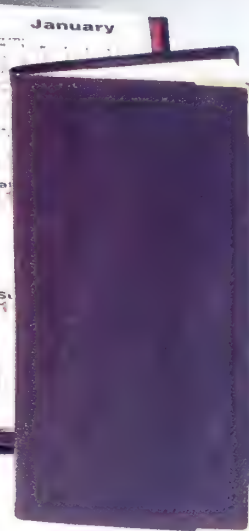
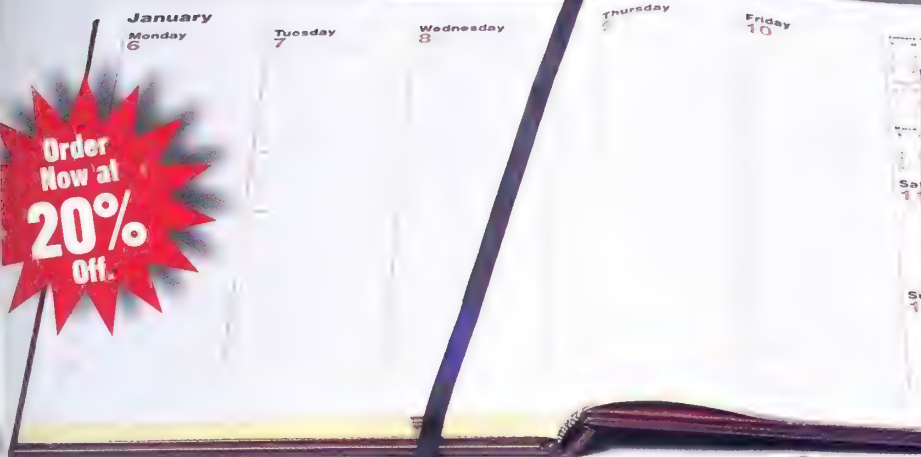
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EDITED BY JOHN TEMPLEMAN

HOW CLINTON IS SEEKING SALVATION AS A STATESMAN

It wasn't the stuff of Nobel Peace Prizes, but it was a welcome breakthrough. On Sept. 28, a beaming President Clinton embraced Israeli Prime Minister Benjamin Netanyahu and Palestinian leader Yassir Arafat after 90 minutes in the Oval Office. They had agreed on the framework for a further Israeli withdrawal from the West Bank—with hopes of completing a peace deal at Camp David in mid-October.

Just the kind of turnaround that the battered President needs. With his domestic agenda a casualty of the Lewinsky scandal and with Republican gains in Congress in the November elections likely, Clinton needs the global stage to salvage his Presidency. Surprisingly, the chances of a comeback look promising.

It's not just the Mideast talks that are back on track. Already, Clinton's role in forging peace between Protestants and Catholics in Northern Ireland has earned him accolades in Europe. And he has earned plaudits from South Africa's President Nelson Mandela for his efforts to help Africa. His get-tough policy in Kosovo wins bipartisan support at home. And with the Sept. 27 election victory of Gerhard Schröder in Germany, Europe is now stacked with center-left leaders—from Britain's Tony Blair to France's Lionel Jospin—who can work with Clinton.

SMALL CARROT. Clinton won praise from CEOs in his first term for making trade and international economics a cornerstone of foreign policy. Now the crisis in Asia and Latin America offers him a chance to pull the global economy out of its slide. That plays to Clinton's strength in economics. He will press leaders of the world's industrialized countries for coordination in stanching the crisis. Officials hint he may fight at the U.N. to send troops to end the bloodshed in Kosovo.

Can a President in such deep trouble at home continue to bask in the diplomatic limelight? There are still hurdles.



COMFORT: Clinton, Mandela

Clinton hoped to visit India and Pakistan this fall to red tensions between them. After detonating nuclear blasts, b countries agreed to sign the Comprehensive Test Ban Tre eventually. One high-level Indian aide says India has no tion of signing quickly. Besides, he says, a visit by a minished President isn't much of a carrot. So, on Sept. 29, White House abruptly postponed the trip.

Some analysts fear that Clinton's problems are an open invitation to global troublemakers to test U.S. resolve. ministration overtures for a thaw in relat with Iran have been largely rebuffed Tehran. In August, Baghdad ended coop tion with U.N. weapons inspectors, and N Korea shot a rocket over Japan claimin was a missile launch. "They're taking us f ride," says Peter W. Rodman, a national curity expert at the Nixon Center, a con vative Washington think tank.

Then there's Congress, which could be boldened to wrest control of foreign policy ready, isolationist lawmakers are trying stymie U.S. pledges to pay arrears of U dues and to shore up the International netary Fund. And Congress has voted to tfer authority for reviewing satellite ex licenses to the State Dept. from the C merce Dept. Further GOP Senate gains in election could lead to passage of a measure mandating ployment of a national missile defense system—a dec the White House wants to delay until 2000.

Still, Clinton retains a trump card as Commander-in-C When the Administration struck sites in Sudan Afghanistan in retaliation for terrorist attacks, the GOP ership stood by him. For Clinton, looking for problem solve overseas may be the best way to project Preside stature at home.

By Stan Crock in Washington, with bureau re

GLOBAL WRAPUP

SLOVAKIA BOOTS OUT MECIAR

► The Slovak opposition hailed "the end of a nightmare" as they defeated Prime Minister Vladimir Meciar in Sept. 27 elections. But business leaders fear the new center-left coalition may struggle to find a coherent economic strategy. Meciar's likely successor, Christian Democrat Mikulas Dzurinda, pledged to double state pensions and average wages and get unemployment below 10%, from 14%—all while cutting taxes.

Still, Dzurinda's win should burnish

Slovakia's international standing. It was passed over for fast-track European Union and NATO membership last year because of human-rights abuses during Meciar's six-year rule. Brussels is now hinting that EU accession talks could start by yearend.

THAILAND AVERTS A NEW CRISIS

► Thailand's Prime Minister, Chuan Leekpai, averted a political crisis by recruiting the biggest opposition group, the Chart Pattana party, into his coalition on Sept. 29. The move adds 51 seats to Chuan's small 23-seat

majority in the lower house of Parliament. It will enable him to enact k reforms, such as toughening the co try's bankruptcy laws, needed to extricate the country from its crisis.

To date, Chart Pattana has oppo reforms required by the Internatio Monetary Fund and other creditors the lengthy closed-door coalition ne tations, it agreed to accept control the Industry Ministry in exchange dropping a demand for the key Fi nance or Commerce Ministry posts. Both will remain in the hands of Chuan's reformist Democrat Party.

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COMMENTARY

By Aaron Bernstein

THE HEALTH-CARE NET IS SHRINKING

For the past several years, no one has been complaining much about affordable health coverage or the plight of the uninsured—and for good reason. Medical costs have been so tame that companies and employees alike are paying less for health insurance, after inflation, than in the early 1990s. A record share of the population is working, giving more people access to employer plans. And wage hikes are beating inflation, so more families can afford co-payments.

Economic conditions have been nearly ideal—but how deep is their impact? Not very. True, the share of the population with employer coverage has stopped its downward spiral. But coverage hasn't recovered any lost ground either, leaving the ranks of the uninsured at high levels. The point was driven home on Sept. 25, when the Census Bureau released 1997 health coverage statistics. In 1987, employers covered 69% of the nonelderly population. By 1993, the level was only 64%, where it has been stuck ever since, according to an analysis of Census data by Washington-based Employee Benefit Research Institute (EBRI) (chart).

REVERSE COURSE. This is bad news, since at least some of the current positive economic factors are sure to reverse course in the next year or two. Medical costs are starting to rise again, with premiums jumping 3.3% this year, according to KPMG Peat Marwick. If that continues, or if job growth or wage increases turn down, medical coverage is certain to slide more—landing more people suffering from more acute illnesses in



VULNERABLE: Robert Thompson's company was hit with a 50% rate hike

emergency rooms of hospitals. Unfortunately, welfare reform will contribute to the problem, because former recipients usually find low-wage jobs that are the least likely to offer insurance. "It's only going to get worse," says Victoria Caldeira, a health-care lobbyist for the National Federation of Independent Business, which represents small employers.

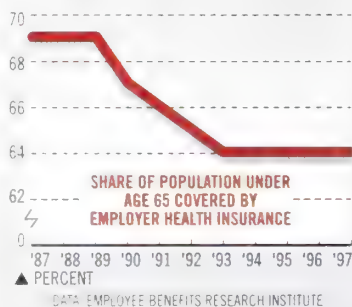
Nor is relief in sight. Since the flameout of Hillary Rodham Clinton's 1994 health-care initiative, Demo-

crats haven't had many new ideas for preventing the return of big cost increases, and neither have Republicans or business groups. Unless policymakers start to grapple with costs now or find new ways to help the uninsured, we may be caught flat-footed when the problem flares up again.

SAVINGS. Still, there's no question that the past few years have helped alleviate the crisis of the early 1990s. The shift to managed care and lower overall inflation has worked wonders on expenses. After years of double-digit increases, premium hikes lagged the medical inflation rate from 1994 to 1997, according to annual surveys by KPMG. As a result, inflation-adjusted employer spending on employee health care has plunged by 22% since 1992, to \$1.13 an hour, according to an analysis of Bureau of Labor Statistics data by the Economic Policy Institute, a Washington think tank.

Employers haven't shared much the savings with their employees, though. Workers paid an average of \$120 a month for family coverage last year. That's down just 5% from 1992, after adjusting for medical inflation, according to KPMG. Even though employers are offering health insurance plans to slightly more people than in 1989, three recent studies show, fewer employees are signing up because of the cost. "The main problem is affordable coverage," says Thomas H. Rice, a professor of public health at the University of California at Los Angeles who co-authored one of the studies.

EMPLOYER COVERAGE HASN'T REBOUNDED





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coverage or shift costs to workers, some of whom will drop their insurance coverage. Small employers are particularly vulnerable. Tugboat operator Thompson Marine Transportation Co., based in Morgan City, La., got hit with a 50% increase last month for the health insurance it offers its 25 workers. The company now shells out \$6,200 a month to keep them covered, says owner Robert J. Thompson. "I wouldn't discontinue coverage if it goes up again, but I might have to ask my people to pay more," he says.

WELFARE MOTHERS. Not surprisingly, the pool of uninsured Americans climbed again in 1997, by about half a percentage point, to 18.3% of the nonelderly population, according to EBRI. Declining welfare rolls are a key reason. Although many low-wage workers remain eligible for Medicaid, they're not getting it. Health experts say part of the explanation may be that many states have done a poor job of providing the forms and assistance that these workers need to re-enroll after leaving welfare. In addition, many former welfare mothers may not realize that they're still eligible for Medicaid if they earn near-poverty incomes. Whatever the cause, Medicaid enrollment has declined by nearly two percentage points since 1993, to 11% of the population last year, according to EBRI. Since employer coverage is unchanged, more Americans are left uninsured.

Unfortunately, the problem is likely to get worse. Welfare reform's new time limits will probably force 1.5 million more recipients off the rolls in the next couple of years, according to studies. Many will land jobs with no insurance. And if unemployment edges back up, they'll probably be among the first to be left out in the cold.

Employer-based health insurance served the country well for half a century, ever since company plans proliferated in the 1940s. That model began to fray in the late 1980s. Given the high price of care today, it's not clear that small employers or those that pay rock-bottom wages can afford to remain in the game. Either we come up with a way to help them, or the system may soon break down even further.

Bernstein covers the workplace from Washington.

Government

PEOPLE

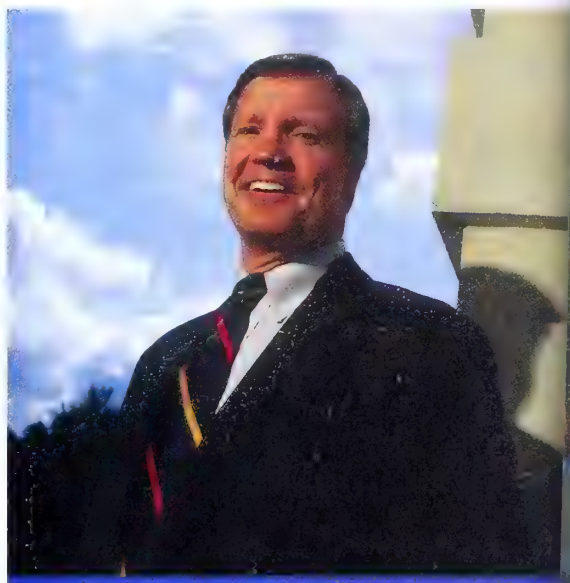
THE SMART MISSILE AIMED AT CLINTON

Will Chris Cox build a damning China-connection case?

For now, the Clinton Administration is breathing a sigh of relief over the House Judiciary Committee's inquiry into the Monica Mess. With the American public taking a very European approach to *l'affaire Lewinsky*, Illinois Representative Henry J. Hyde, the beefy, white-maned committee chairman, is battling Democratic charges that his probe is becoming a partisan food fight. But another serious threat to the Clinton Presidency may be emerging in the person of Christopher Cox, a lean, low-key Republican lawmaker from California.

A pragmatic conservative who has led fights in Congress to limit investor lawsuits and to keep the Internet tax-free, Cox heads a special panel that is exploring China's acquisition of sensitive U.S. technology. The results of the secret inquiry could be highly damaging to the White House. And unlike the sordid Lewinsky saga, Cox's investigation deals with Presidential policy: Did Clintonites and companies that contribute generously to Democrats hand over sophisticated U.S. knowhow that enhanced Beijing's military might?

LIMELIGHT. The inquiry stems from Clinton's February decision to allow Loral Space & Communications Ltd. to launch a satellite on a Chinese rocket despite Justice Dept. objections. Justice was probing alleged leaks of satellite technology to China by Loral and feared the O.K. could undermine any criminal



THE COX FILE

BORN Oct. 16, 1952, St. Paul, Minn.

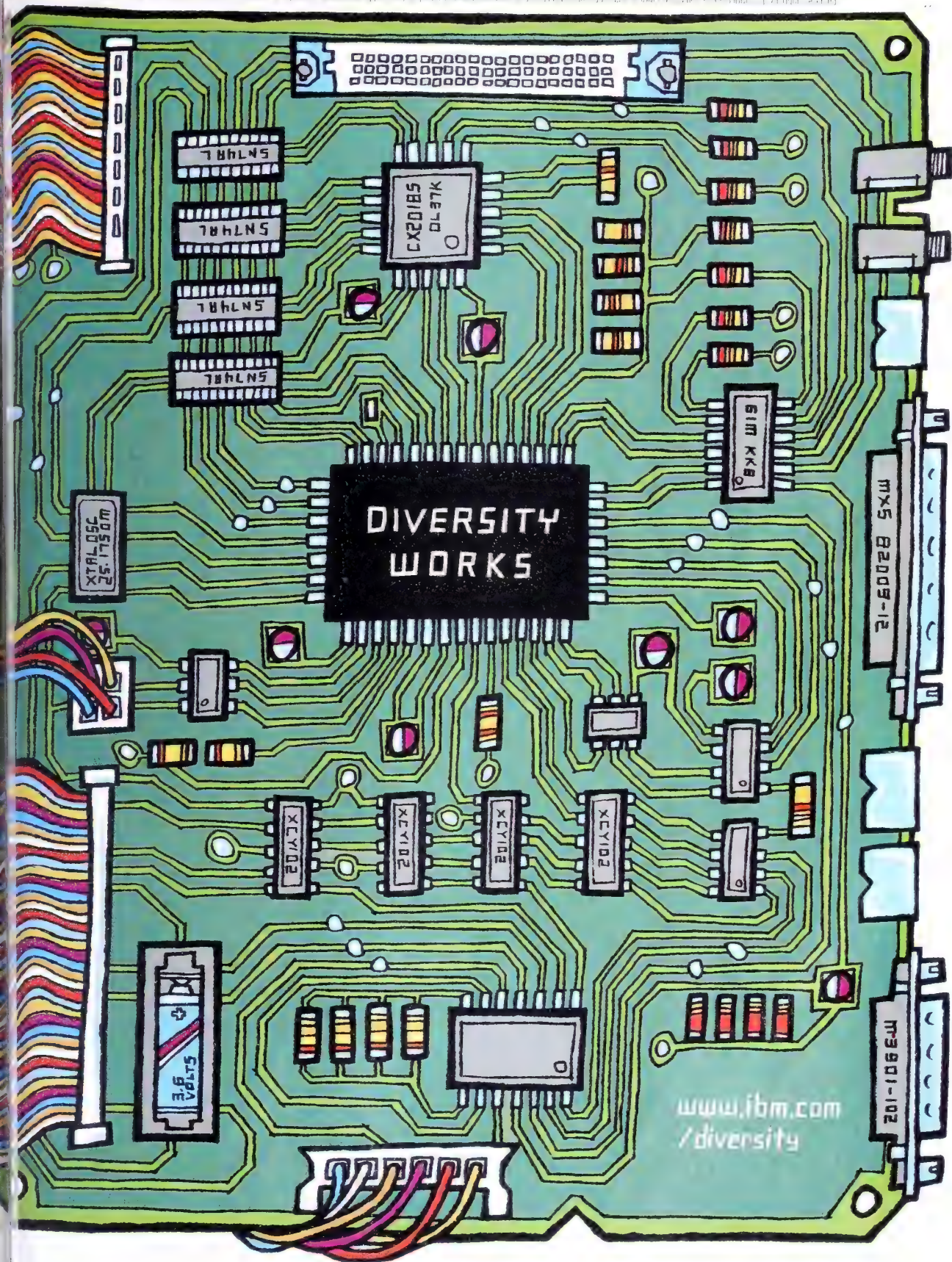
EDUCATION BA, University of Southern California (in three years); JD and MBA, Harvard

WASHINGTON Elected to the House from California's 47th district, 1988; senior associate counsel in the White House, 1986-88; lawyer, Latham & Watkins, 1978-86

PERSONAL Married to the former Rebecca Gernhardt; three children: Charles, 5, Katie, 4, and just-born Kevin; speaks Russian

case it might bring against the company. Another House panel is investigating whether the President approved a launch to help out Loral CEO Bernard Schwartz, the Democrats' top software donor in '96. Cox's committee will report its findings in January, focusing on the extent to which federal policy and national security were promised by the deal.

And it has expanded its scope to include possible illicit transfers to China of U.S. supercomputers, exotic materials and manufacturing techniques as well as satellites. "We are focused not



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Government

on inadequacies in existing [export control] policy but also on violations... of policies that were supposed to be in place," says Cox.

The probe is sure to keep Cox, 45, in the limelight and help push him up the GOP leadership ladder from the No. 5 job, chairman of the House Republican Policy Committee. Cox is a natural choice to oversee the China-connection probe, which entails complex technical issues. With both a law degree and an MBA from Harvard, he is considered one of the best intellects in the House by Democrats and Republicans alike.

He's also one of the Hill's top techies. Cox, who represents Orange County, grasped the importance of the Information Age back in 1984, when he and his father founded a company that sold English-language versions of the Soviet Communist Party newspaper *Pravda*. Cox, who ran the venture while prac-

"opt-in" class actions, which would require lawyers to seek permission from all individuals affected by such cases. He also wants to curb lawsuit damages for pain and suffering.

About the only issue on which parts company with business is China. Angered last fall by Clinton's refusal to punish Beijing for human-rights abuses and missile sales to Pakistan, he fashioned a package of China sanctions. Though the penalties are mild and not yet law, they rankled business lobbyists. "He's trying to stir the pot without moving our relationship with China forward," says Myron A. Bantli of the U.S. Chamber of Commerce.

Cox occasionally comes across as intellectually overbearing to fellow lawmakers. But his unabashed support for free markets, lower taxes, and small government plays well with voters. His well-heeled Southern California

Cox, considered one of the House's top brains, is a natural choice to oversee the Clinton-China probe, which entails complex technical issues

ticing law in California, assigned and edited the work of translators scattered around the country via computer.

STIRRING THE POT. Today, while many colleagues are still having trouble finding their own Web sites, Cox is crafting legislation to keep the Internet free of red tape and taxes. Already a hero in Silicon Valley for championing a law to curb shareholder lawsuits, Cox is winning accolades in corporate circles for his latest crusade. "He's an incredibly smart guy who understands the issues in a very detailed, sophisticated way," says Jill Lesser, America Online Inc.'s director for law and public policy.

The courtly Cox took up the cause of securities litigation reform while specializing in corporate finance and venture-capital law at Latham & Watkins in Orange County from 1978 to 1986. The job convinced him that "the whole system of resolving disputes is broken. It's way too expensive, takes forever, and inflicts great pain on participants." In Congress, he led the fight to make it harder for investors to sue companies because their stock prices tanked. The bill became law in 1995—the only one enacted over Clinton's veto. In March, grateful execs contributed \$34,400 to the Cox war chest via the Technology Network Political Action Committee, a conduit for high-tech companies.

Cox's new legal campaign: a push for

strict, a bastion of Reaganism. In 1989, Cox served a stint in Reagan's White House. While there, he helped draft the "long arm" statute that lets the U.S. government go after terrorists abroad. "We can thank his hard work that we have the ability to apprehend terrorists abroad and bring them back for trial," says former colleague Oliver L. North. With North on the hustings for 1996, Cox narrowly clinched his seat in 1994. Since then, he has won reelection easily.

Despite his conservative credentials, Cox builds coalitions with Democrats. "There have been no disagreements that couldn't work out," says Representative Norm Dicks (D-Wash.), the China panel's top Democrat.

On both Internet bills, he has teamed with liberal Democratic Senator Wyden of Oregon and worked closely with White House aide Ira C. Magaziner, a favorite GOP whipping boy. Cox has done an excellent job of developing [the Internet Tax Freedom] bill, guiding it through difficult negotiations, says Magaziner.

But will Democrats still be pro-Cox if his panel uncovers evidence that the White House compromised national security? If Cox manages to make a case against Clinton, the American electorate may not be as forgiving as he has been over a fling with an in-

By Amy Borrus in Washington

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need to know
this stuff,

we wouldn't
interrupt your
weekend.

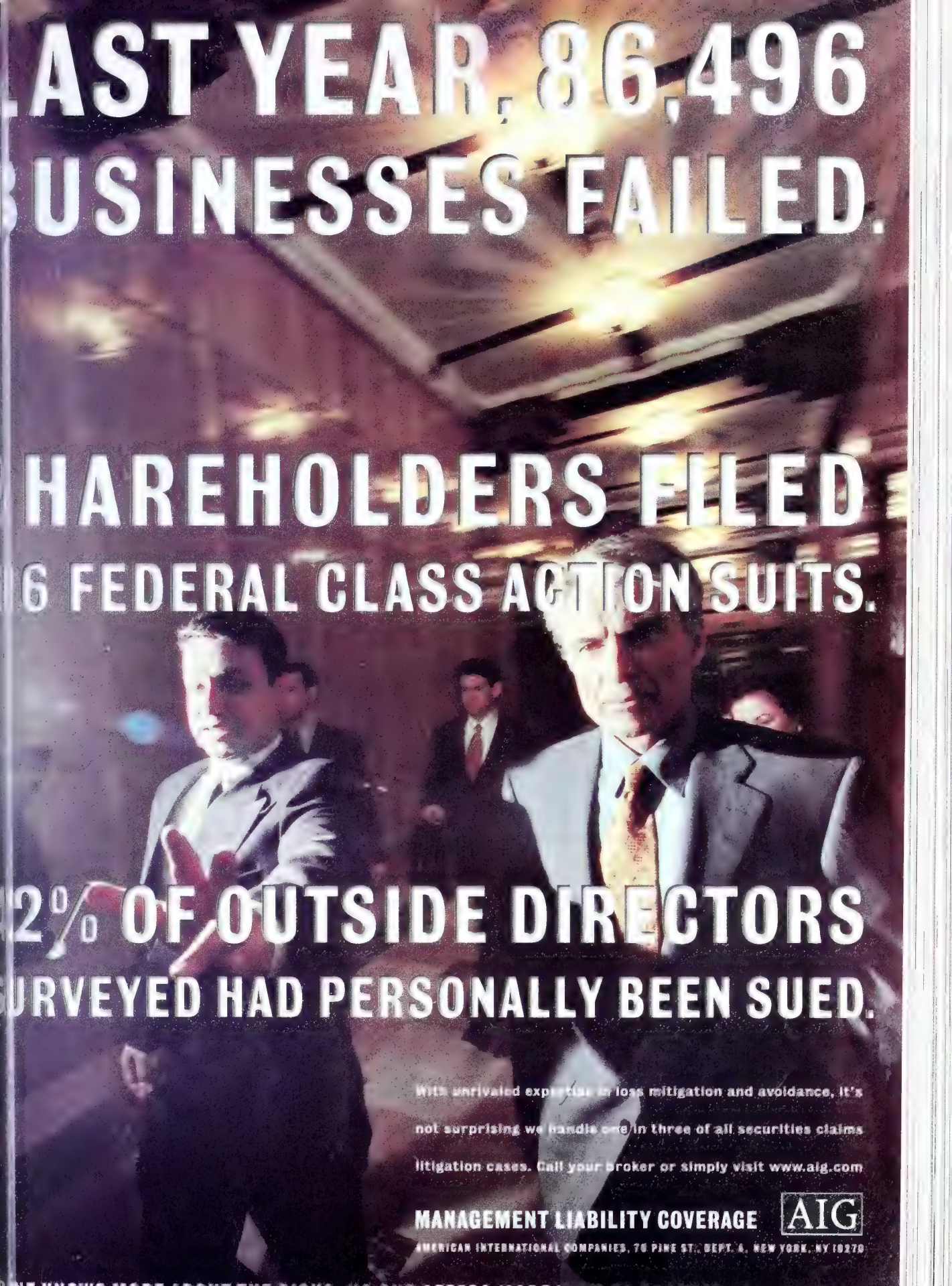
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GUESS WHO'S RAKING IT IN FROM GAMBLING

As casinos throw money at the GOP, the Religious Right fumes

When Senate Majority Leader Trent Lott and other powerful lawmakers bundled into a casino owner's private jet and headed toward Las Vegas last November, it wasn't for a weekend of slots and showgirls. The Republicans were guests of honor at a gambling industry fund-raiser. With a take of nearly \$700,000, the event made gambling interests the second-largest business contributor to the Senate Republicans' political committee in 1997-98, following the insurance industry.

But not everyone in the party is wild about the GOP's winnings. Religious conservatives view the gambling industry's political clout with a combination of loathing and alarm. "I think it's a bad idea for party leaders to be running out to Las Vegas and holding fund-raisers in casinos," says Gary Bauer, President of the Family Research Council and a Presidential aspirant. "It's like sticking their finger in the eyes of a whole lot of people around the country that they depend on every November."

No issue more lucidly points up the division within the Republican Party between business interests and social conservatives. Does the GOP side with a booming industry—one that has pumped more than \$2.3 million into GOP coffers for the '98 elections? Or do GOP leaders heed the antigambling demands of their most reliable supporters and their leading source of grassroots volunteers?

TOUGH TALK. The moralists are turning up the heat on national Republican leaders. Representative Frank R. Wolf (R-Va.), a leading foe of the gaming business, is calling on his party to forswear gambling dollars. And social conservatives vow to make gambling an

issue in the 2000 GOP Presidential primaries. Senator John D. Ashcroft (R-Mo.), a potential Presidential candidate closely aligned with Christian conservatives, condemned gambling as immoral in a speech to Southern Republican activists in March at a casino complex in Biloxi, Miss. Texas Governor George



W. Bush, the Presidential frontrunner, also is an outspoken foe. Says Ralph E. Reed Jr., a former executive director of the Christian Coalition who is informally advising some White House hopefuls: "Any Presidential candidate who receives casino support is going to come under heavy fire."

That kind of talk has the gaming industry running scared. Fearful of new federal regulations, or "sin" taxes, it's doling out soft-money donations like free

Gambling Giving

ELECTION	TOTAL DONATIONS TO BOTH PARTIES	REPUBLICANS' SHARE
1992	\$1,193,323	36%
1994	2,636,305	49
1996	6,775,400	46
1998*	3,618,668	66

*Estimate based on Federal Election Commission data
DATA: CENTER FOR RESPONSIVE POLITICS

meal chits. While the industry historically has generously donated to both parties, the nonpartisan Center for Responsive Politics found that 66% of largesse in 1997-98 has gone to the Republicans who control Congress. Among the biggest winners this election cycle are the National Republican Senatorial Committee (\$717,500) and the Republican National Committee (\$674,150), according to the CRP. And more donations are expected at another Las Vegas fund-raiser for House Republicans scheduled for Oct. 14.

To guard its flank in Washington, the industry hired former Republican National Committee Chairman Francis J. Fahrenkopf Jr. to head its trade group, the American Gaming Assn. And on Capitol Hill, it has invested more than

\$3 million in the past two years in a bipartisan team of well-connected lobbyists. Prominent Republicans include Kenneth M. Duberstein, former Reagan White House chief of staff, and Daniel P. Meyer, former chief of staff for House Speaker Newt Gingrich.

Casinos fear that gambling could be the next vice targeted by lawmakers, as tobacco was this year. They're also nervous about recommendations of a blue-ribbon congressional commission on gambling, slated to issue a report in mid-1999.

"We don't participate in the process, we get run over by it," reasons one industry executive.

That hasn't happened yet. Indeed, the gaming biz has rung up a string of legislative victories this year. Notably, it buried a bill to rescind the tax deductibility of gaming losses. But its winning streak has led moralists to the level of their rhetoric. Says Bauer, "Look what [gambling] does to families, the role of organized crime.... I think the American people would respect a party that said, 'We're not going to take that money.'"

Gambling lobbyists say they'll resist any efforts by religious conservatives to blunt their political clout. "Their ultimate goal is to outlaw legal gaming in the country," says Fahrenkopf. Republican pols in the middle of the deal are sure to agonize over the issue as the way to the bank.

By Richard S. Dunham in Washington

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EDITED BY AMY DUNKIN

SAYING ADIOS TO THE OFFICE

Now that her commute to the office lasts all of 10 seconds, Vicki Hall has lots of time on her hands. A senior communications analyst for Visa International, Hall used to drive some 2½ hours each day to and from Visa's San Francisco headquarters. After moving to Pensacola, Fla., Hall, a single mother, is still taking care of business. With the blessing of her California bosses and armed with a company-paid PC, fax, ISDN phone line, and storage shelves, Hall has turned a spare bedroom into an office. "Telecommuting gave me my life back," she says.

an added boost from a strong economy in which employers must make accommodations to attract the best and brightest workers. There are also environmental and political pressures as companies respond to Clean Air Act provisions that aim to cut traffic. And businesses want to pare real estate costs by creating "hoteling" arrangements in which, say, 10 people share a single cubicle on an as-needed basis. Companies are finding that telecommuting can boost productivity

5% to 20%, according to Jack M. Nilles, author of *Managing Telework* (John Wiley & Sons, \$29.95).



TELECOMMUTING

As professional men and women attempt to do justice to their careers while attending to family and personal needs, more and more are working without visiting the office more than once in a blue moon. The appeal is enormous. At home, you can spend more time with the kids, work in casual clothes, and tailor a schedule that lets you tackle your job at odd hours. Some 9.9 million people work outside their main corporate offices at least three days a month, up from 9.1 million in 1997 and 5.4 million in 1993, according to Raymond Boggs, director of home-office research for International Data Corp. in Framingham, Mass.

Telecommuting has gotten

Technology is helping people break free of the office. With laptops, speedy modems, the Internet, and the emergence of corporate intranets, jobs are becoming portable. Employers and employees can easily swap E-mail and share PC documents from afar. This cuts down on faxing and overnight-courier costs.

Is telecommuting for you? Nearly 75% of teleworkers responding to an AT&T survey last year said they were more satisfied with their personal and family lives than before they started working at home. But telecommuting is not for every person or job, and you'll need a massive dose of self-discipline to pull it off. Ask yourself if you can perform your duties with-

out the boss breathing down your neck. On the other hand, would you go stir-crazy without being able to schmooze with officemates?

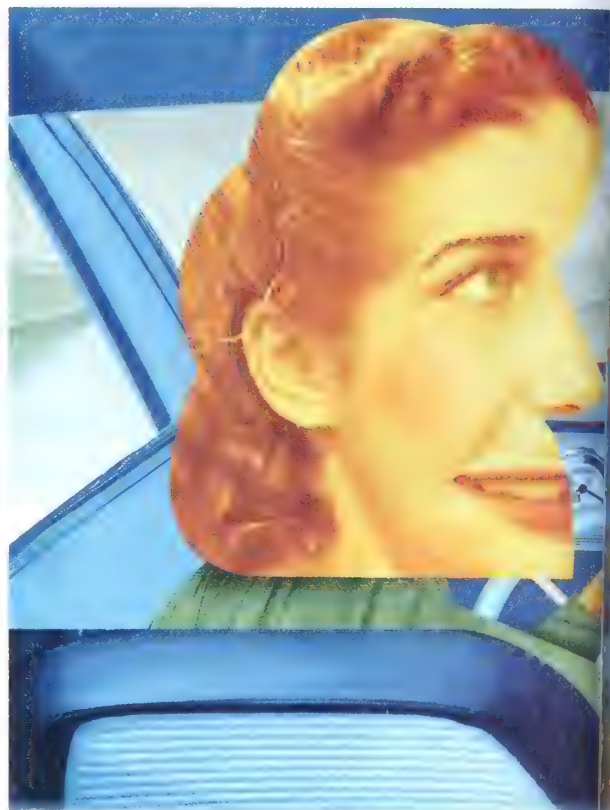
Many companies insist that you iron out a schedule with your supervisor before you begin. You may prefer to work at 6 a.m. and hit the links at 3 p.m.—just be sure you're available for those 9 a.m. meetings. Not every company will require formal training before you set up a remote office, but it's a good idea to sound out your boss about his or her concerns.

APPEARANCES COUNT. It's equally smart to assuage the fears of co-workers. Your colleagues may become resentful if they think you're on paid vacation or suspect they'll get saddled with extra work in your absence. As a result, you may want to trade favors with your cohorts—by covering for them if they leave early one day, for example. And make sure they know they can call you at home. Appearances count: If you choose to work two days a week at home, you may not

want to make them Monday and Friday, advises telecommuting consultant Gil Gale in Monmouth Junction, N.J. Peers might think you're running long weekends.

It's also imperative to set up ground rules with your family. The good news on telecommuting is that you can be close to your loved ones. That's also the bad news. Spouses and small children have to understand even though you're in the house, you are busy earning a living. It's fine to throw a few loads of laundry in the washer the door when the plumber comes. It's another thing to take the kids to the mall or let them play on your office PC.

Clearly demarcate your workspace by using a separate room with a door that can shut. Let your family know that, emergencies accepted, the space is closed during working hours. Some employees wear separate badges or business attire at home to alert the family that they do not want to be disturbed.





I have infants or toddlers at home, I can arrange for child care. Telecommuting is not a substitute for dependent care," says Barbara M. Reeves, a program manager at Boeing. "With a child, you're really trying to hold down two jobs—probably not doing very well either one." If you get down to business, you may have to work from home to remain in the loop. Why so many telecommuters stay at home only a few days a week. Aside from elbowing with colleagues and cohorts, there are other situations where time is essential. In five telecommuters' words to the AT&T study

indicated that they felt more isolated working at home. But some teleworkers worry that being out of sight means being out of mind, and that that will hurt their chances for a promotion or a bonus. Moreover, you may be concerned that if bad times hit, you'll be the first to get sacked.

BE A STAR. The best way to eliminate such concerns is to produce. "You need to establish your credibility," says Betty Sun, who works from her house in Bethesda, Md., as an acquisitions editor for publisher John Wiley & Sons in New York. Of course, while it's important to put in a full day of work while telecommuting, also remember that there's a time to

leave the office. When the lines between your home and office blur, it can be hard to pull yourself away.

Maintaining the balance has not been a problem for Sun. She has been promoted since she began telecommuting and now manages two New York employees from a distance. But there may come a time when you'll have to ponder a difficult question: Would you rather climb the corporate ladder or the stairs to your home office? The higher up you move in your organization, the more likely it is that your presence at headquarters may be required at all times. Telecommuting can be terrific at certain stages of your life and

career. But when the kids are older, you may be ready to return to the office full-time.

Even though the telecommuting phenomenon continues to mushroom, you may still encounter old-fashioned employers who are resisting the trend. But if you're a star performer, lots of companies will let you telecommute if that's the way to hook you. "The whole drift of the '90s is to introduce flexibility into work flow," says Thomas E. Miller, a vice-president for Cyber Dialogue, a New York-based research and consulting firm. That's good to know if you find the back-and-forth pull of train or car commuting is pulling you apart at the seams. *Edward C. Baig*

KEEP THE BOSS HAPPY

Find out your manager's concerns before you begin working at home. Agree on performance standards, and meet those goals.

SCHEDULE YOUR TIME

Create definite work hours. Attend meetings by phone, communicate regularly with bosses and coworkers, and visit the main office often.

SET UP AN OFFICE

Establish a clear workspace at home. Determine whether your company will pay for home-office equipment.

ESTABLISH GROUND RULES

Let your family know when you cannot be disturbed. If you have small children, arrange for child care during those times.

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COMMENTARY

By Mike McNamee

GIVE TELEWORKERS A TAX BREAK

In Southern California, the Internal Revenue Service encourages its agents to stay off the freeways and telecommute. With computers, E-mail, and IRS-provided secure file cabinets, agents can track cases and prepare for audits from home. But these telecommuting enforcers can't even think about claiming a home-office deduction on their Form 1040s. To deduct work-related expenses at home, they—and you—have to show that telecommuting is for an employer's convenience. And since those IRS agents could find desk space downtown if they chose, their home offices don't meet the deduction test.

Keep that in mind if you're looking for a tax break for expenses you rack up working from home. Sure, many employers see the value of telecommuting and will underwrite equipment to turn your guest room into a corporate outpost. But for the many telecommuters who cough up cash for their own computers, fax machines, and workspace, the tax code offers little relief.

That's not right. A basic principle of the income tax is that business costs shouldn't be taxed. Big companies deduct most of their expenses. But for home workers—be they telecommuting employees or the self-employed—the bar is higher.

NIX THE KIDS. To prove you're working at home for your employer's sake, a letter from the boss should do the trick. But the IRS can demand more, including a corporate policy guaranteeing the same deal to all similar employees. Mixed-use equipment poses another problem. No one tracks how many hours office workers spend playing games on the Internet. But share your home PC with your kids, and you're expected to log your keyboard hours vs. theirs and claim only your share of computer costs on your tax return. And if your kids play in your office, the IRS will question whether it's a separate space used exclusively for work. If

it's not, forget about deducting utilities, rent, or depreciation.

Even if a telecommuter can claim deductions, they're not worth much. Unreimbursed employee expenses fall into a catch-all category of "miscellaneous deductions." The two-thirds of taxpayers

who take the standard deduction can't claim those expenses at all. Even

itemizers can deduct only those costs that exceed 2% of adjusted gross income. Unless you have lots of other miscellaneous deduction employee expenses aren't likely to add up to a tax break.

How could Washington level the playing field?

First, recognizing the environmental and social costs of commuting, Congress could give employers a small tax credit for wages earned at home. Then, it could move telecommuters' unreimbursed expenses to the front of the tax form, as an income adjustment fully available to itemizers and non-itemizers. The IRS could help by devising common-sense tests for expensing equipment and home-office space used predominantly for business for employees and the self-employed.

RELIEF. Self-employed home workers have it better—in some ways. Most of their expenses reduce pretax income dollar-for-dollar. They'll also

benefit from a 1997 tax law that, starting next year, will let them deduct a home office used for managing work performed elsewhere. That reverses a 1993 court ruling that barred, say, a plumber from claiming a home office because his actual job was repairing pipes at clients' houses.

But the self-employed still have plenty of tax gripes. The biggest—cap that lets them deduct only 45% of their health-insurance premiums will be fixed if the Republican tax bill now in Congress escapes a threatened Presidential veto.

Stay-at-home workers will never have the resources big companies use to shrink their tax tab. But as their numbers proliferate, they deserve the benefit of the doubt. Lots of work is going on in home offices. Congress and the IRS should make allowances for this economic reality.

McNamee covers tax issues from Washington.



Tips for Dealing With Uncle Sam

GET IT ON PAPER

Your chances of claiming work-related expenses on your return improve with a letter from your boss stating that the arrangement is for your employer's convenience.

REIMBURSEMENT BEATS WRITING OFF

Better to get 100% of an expense from your employer than a tax savings worth at most 39.6%.

WATCH YOUR PHONE COSTS

Don't deduct any share of your basic service. But you can write off a second phone line or business services, such as voice mail.

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u're looking to land a

job that lets you clock in from home, you'd do well to find a company like Cisco that has formal telecommuting policies in place. Although ad hoc arrangements are still common, they are often inconsistent and can be seen as unfair. Fortunately, an increasing number of companies are instituting formal telecommuter programs that spell out training require-ments and make clear who will pick up what costs (table, page 156). That lets you know telecommuting enjoys the support of top management and can mean the difference between a commitment to working out the



TELECOMMUTING

kinks and a transfer back to the office, says Joseph Parente, who runs KPMG Peat Marwick's telework-consulting practice.

Companies that top most consultants' lists of good employers for telecommuters tend to be in high-tech or knowledge-driven industries. But telecommuting can work in any field, provided a job requires more time on the computer or phone than in face-to-face meetings.

A successful program needs employees with the discipline, independence, and organization to make it work, and managers who don't confuse time spent at the office with output or effectiveness. IBM "didn't do as good a job initially" as it could have, says Bob Egan, who manages the company's telecommuting program from his home in Salt Lake City. The problem:

At Merrill Lynch, would-be teleworkers can do a two-week dry run

While telecommuters spent less time gossiping, they also had fewer opportunities to talk shop. Rather than scrap the program, IBM decided to schedule meetings and other social interactions that used to happen automatically. Today, about 20% of IBM's 270,000 global employees spend at least two days a week at home or visiting clients.

STANDARDS. Some companies go to great lengths to avoid making mistakes when putting telecommuting programs in place. Merrill Lynch lets employees and managers try telecommuting on for size during a two-



week simulation in New York and elsewhere. While working with gear they will take home, employees communicate via phone or E-mail. Face-to-face encounters are forbidden. "It gives them an idea of what to expect," said Camille Manfredonia, the program's director.

But dry runs, questionnaires, and other evaluation tools are only part of a successful program. Like Merrill, Arthur Andersen's Performance & Learning group in St. Charles, Ill., requires prospective telecommuters to attend training sessions,

ask employees who set up shop in the corner of the family room to tell the kids to play elsewhere during work hours.

PAT ON THE BACK. Although training tends to focus on employees, companies that are serious about telecommuting usually recommend that managers attend sessions, too. At Merrill Lynch, managers are taught to spot problems and to pat telecommuters on the back from afar. "The people I have reported to have all had a simple attitude, which is we don't care how you do it or where you do it, just be

ends up costing more in terms of support," says Gil Gordon, a telecommuting consultant in Monmouth Junction, N.J.

Still, even the best programs shift some of the cost of doing business onto employees' shoulders, says Christena Nippert-Eng, an assistant professor of sociology at Illinois Institute of Technology. AT&T's telecommuters typically receive laptops, cellular phones, and second phone lines. IBM supplies those, plus pagers and printers. But few companies pay a portion of a telecom-

says Nippert-Eng, who estimates that at least 20 of the arrangements she mediated failed.

Perhaps the biggest is the very thing that makes telecommuting attractive: distance. Companies are damaging their cultures by discouraging informal problem-solving. Indeed, the need for periodic in-person meetings is acute at companies like IBM, which are away with regular office telecommuters in favor of shared cubicles they use when they come in to office.

REQUIRED VISITS. In some companies require telecommuters to stop at the office—if only for one or two a week. Arthur Andersen also hosts informal lunches for its St. Charles telecommuters. Despite the growing pains, Dennis Lis, who markets IBM products to local governments in

Telecommuting-Friendly Employers

COMPANY	PERCENTAGE OF WORKFORCE THAT TELECOMMUTES	SPECIAL FEATURES
AETNA	2%	Telecommuter is assigned an office "buddy"
ARTHUR ANDERSEN	20*	Conducts safety inspections of home offices
AT&T	55**	Manager, employee work out details
BOEING	1***	Rules differ for business unit
CISCO SYSTEMS	66	24-hour technical support, ergonomic furniture required
GEORGIA POWER	5†	May soon allow some to work at company sites near home
HEWLETT-PACKARD	8	Recommends ergonomically correct office
IBM	20	Teleworkers use shared space in the office
MERRILL LYNCH	5	Employees can test telecommuting in two-week simulation
THE LEISURE CO./AMERICA WEST	16	Arranges monthly potluck team dinners to keep everyone in touch

*Performance & Learning group

**Managers

***Washington state only

†Atlanta headquarters employees

DATA: BUSINESS WEEK

where topics include time management and virtual teamwork. Both companies also inspect home offices to make sure safety standards are met, such as having sufficient lighting. It's typically up to the employee to maintain a safe work environment.

Because telecommuting blurs the line between home and work, good programs set standards designed to create boundaries. "Setting up a workspace on a card table is not a good long-term solution," says David Mead, CEO of Telecommuting Success, a Colorado consulting firm. Few companies require telecommuters to devote an entire room to work. But many will

productive," says Susan Scherbel, a Merrill managing director in investment banking, who began telecommuting eight years ago, following the birth of the first of her three children.

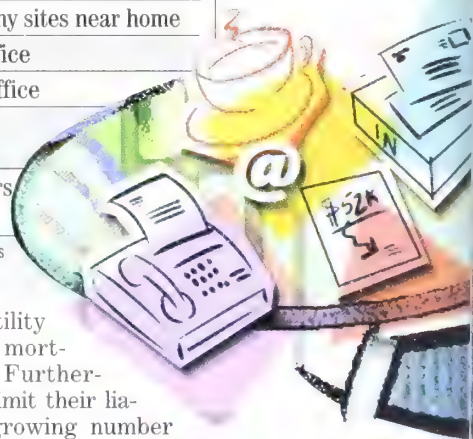
When training is complete, consultants advise managers and subordinates to hammer out written agreements covering everything from what work will be done at home to how accessible the telecommuter will be. Experts also agree that companies should foot the bill for essential equipment, although what's essential varies by company and job. "While it's tempting to require employees to use their own computers, my experience is that it

muter's utility bill or mortgages. Furthermore, to limit their liability, a growing number of companies require ergonomically correct chairs and desks—an expense employees often assume.

Although the telecommuter ranks are growing, many companies have yet to accept the idea of a remote workforce. Only a third of the more than 1,800 companies William M. Mercer recently surveyed offered employees the option to telecommute. Some existing programs are hamstrung by resistant managers, isolated employees, and insufficient opportunities for teamwork,

California from her home from client's offices, telecommuting has been a big plus for her career. Being close to clients, Lis brings in twice the revenue she did four years ago when she worked from IBM office in Los Angeles. Still, Lis says her colleagues often get together face to face to hash out work problems. Even telecommuters have something to gain by gathering around office water cooler from time to time.

Anne Te



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Business Week Index

PRODUCTION INDEX

Change from last week: 0.2%
Change from last year: 5.8%



The production index was up fractionally in the week ended Sept. 19, while the weighted index fell 1%, to 136.1, from 137.5. After seasonal adjustment, steel production was down 10.4%, and the rate of capacity utilization was only 79%, the lowest it has been since June. Auto, truck, coal, and lumber production was also down. Gains in loadings of motor vehicles, oil, and crushed stone, sand, and gravel helped push up the rail-freight index this week. Electric output was up 3.1%, and lumber was up 5%.

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FINANCIAL INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
PRICES (9/25) S&P 500	1044.75	1020.09	10.5
RATE BOND YIELD, Aaa (9/25)	6.35%	6.37%	-9.7
SUPPLY, M2 (9/14) billions	\$4,288.4	\$4,277.6r	8.0
CLAIMS, UNEMPLOYMENT (9/18) thous	292	300r	-5.2
GE APPLICATIONS, PURCHASE (9/25)	283.6	278.3	30.7
GE APPLICATIONS, REFINANCE (9/25)	2,682.7	2,269.9	288.0

Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Association. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
FUNDS (9/29)	5.44%	5.38%	5.81%
GOV. BOND (9/29) 3-month	5.08	5.31	5.53
RATES OF DEPOSIT (9/30) 3-month	5.25	5.42	5.63
MORTGAGE (9/25) 30-year	6.81	6.84	7.46
FIXED RATE MORTGAGE (9/25) one-year	5.65	5.73	5.67
(9/25)	8.50	8.50	8.50

Federal Reserve, HSH Associates, Bloomberg Financial Markets

In the production indicators are seasonally adjusted in computing the BW index (chart); other components (estimated and not listed) include machinery and defense. 1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (9/26) thous. of net tons	1,929	1,899#	-13.6
AUTOS (9/26) units	127,412	128,526r#	1.3
TRUCKS (9/26) units	135,311	137,003r#	-6.5
ELECTRIC POWER (9/26) millions of kilowatt-hrs	68,881	71,953#	7.6
CRUDE-OIL REFINING (9/26) thous. of bbl./day	14,815	15,051#	-3.1
COAL (9/19) thous. of net tons	22,087#	21,785	1.8
LUMBER (9/19) millions of ft.	490.4#	418.0	1.6
RAIL FREIGHT (9/19) billions of ton-miles	27.4#	25.5	3.4

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WWPAl, SFPAl, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (9/30) \$/troy oz.	293.850	288.900	-12.8
STEEL SCRAP (9/29) #1 heavy, \$/ton	85.50	85.50	-37.8
COPPER (9/25) ¢/lb.	78.7	79.4	-19.0
ALUMINUM (9/25) ¢/lb	63.5	64.8	-19.6
COTTON (9/26) strict low middling 1-1/16 in., ¢/lb.	70.90	71.88	-0.2
OIL (9/29) \$/bbl.	15.81	15.54	-25.0
CRB FOODSTUFFS (9/29) 1967=100	225.10	223.22	-6.6
CRB RAW INDUSTRIALS (9/29) 1967=100	281.79	277.85	-16.3

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (9/30)	136.43	136.55	121.02
GERMAN MARK (9/30)	1.67	1.69	1.77
BRITISH POUND (9/30)	1.70	1.68	1.61
FRENCH FRANC (9/30)	5.60	5.66	5.96
ITALIAN LIRA (9/30)	1651.0	1666.0	1740.2
CANADIAN DOLLAR (9/30)	1.53	1.53	1.38
MEXICAN PESO (9/30)*	10.190	10.123	7.748
TRADE-WEIGHTED DOLLAR INDEX (9/30)	110.9	111.4	105.9

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan

THE WEEK AHEAD

SALES

Oct. 5 ▶ Sales of cars and light trucks probably increased to an annual rate of 15.1 million in September, according to a median forecast of economists by Standard & Poor's MMS, a division of McGraw-Hill Companies. Vehicle sales in July and August came in at just over 14.4 million, respectively, down 1% by the end of dealer incentives. General Motors Corp. strike. The sales rebound in September reflects a variety of very generous incentives plus availability of GM models following the strike in late July. Auto makers begin releasing their sales data on Oct. 5. The total number will be

unknown until Ford Motor Co. releases its sales figures on Oct. 5.

NAPM SURVEY

Monday, Oct. 5, 10 a.m. EDT ▶ The National Association of Purchasing Management's index of nonmanufacturing activity likely fell to about 51% in September, from 52% in August. With the Asian crisis hurting the factory side of the economy, the year-old index will likely gain increased notice from the financial markets since it is one of the few indicators covering the service sector.

INSTALLMENT CREDIT

Wednesday, Oct. 7, 3 p.m. EDT ▶ The S&P MMS forecast expects that consumer credit

increased by \$5 billion in August, following a \$5.3 billion gain in July. Household borrowing had slowed earlier in 1998, but picked up in the summer. Consequently, installment credit outstanding once again equals 21% of disposable income, a record high ratio.

UNEMPLOYMENT CLAIMS

Thursday, Oct. 8, 8:30 a.m. EDT ▶ New claims for state unemployment benefits probably totaled about 300,000 for the week ended Oct. 3. Weekly new claims have been near 300,000 since mid-August. The low number of filings continues to suggest that the labor markets remain quite tight even with the slowdown in manufacturing.

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Bernard J. Drackiewicz, Vice President,
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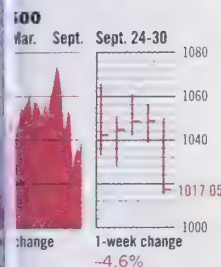
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Investment Figures of the Week

KS



STOCKS

Trading in anticipation of an interest rate cut by the Federal Reserve, the stock market greeted the 25 basis-point move with a big yawn on Tuesday and closed down for the week. The market slid even further the next day, with the S&P 500 ending the week down 4.6%. The industrial average fell 238 points, or 3%, while the economic indicators for Asia and Latin America dealt a painful blow to profits in the U.S. The yield on the 30-year Treasury bond dropping to 6.04%.

U.S. MARKETS

	Latest	% change Week	% change Year
Dow Jones Industrials	7842.6	-3.8	-2.2
NASDAQ Combined Composite	1693.8	-3.8	0.2
S&P MidCap 400	307.0	-3.6	-7.7
S&P SmallCap 600	151.2	-3.8	-19.6
S&P SuperComposite 1500	214.4	-4.5	3.9

SECTORS

	Latest	% change Week	% change Year
Bloomberg Information Age	354.5	-2.7	17.7
S&P Financials	107.0	-8.5	-5.2
S&P Utilities	255.5	0.9	23.7
PSE Technology	319.8	-4.5	-3.9

FOREIGN MARKETS

	Latest	% change Week	% change Year
London (FT-SE 100)	5064.4	-2.9	-4.8
Frankfurt (DAX)	4474.5	-4.8	6.6
Tokyo (NIKKEI 225)	13,406.4	-2.8	-24.9
Hong Kong (Hang Seng)	7883.5	5.1	-47.6
Toronto (TSE 300)	5614.1	-6.7	-20.3
Mexico City (IPC)	3569.9	-8.5	-33.3

FUNDAMENTALS

	Latest	Week ago	Year ago
S&P 500 Dividend Yield	1.52%	1.54%	1.60%
S&P 500 P/E Ratio (Last 12 mos.)	25.0	24.4	24.2
S&P 500 P/E Ratio (Next 12 mos.)*	20.3	19.8	18.8
First Call Earnings Revision*	-5.79%	-5.87%	-1.48%

TECHNICAL INDICATORS

	Latest	Week ago	Reading
S&P 500 200-day average	1065.8	1063.9	Negative
Stocks above 200-day average	22.0%	20.0%	Positive
Options: Put/call ratio	0.57	0.67	Negative
Insiders: Vickers Sell/buy ratio	0.65	0.66	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

BEST-PERFORMING GROUPS

	Last month %	Last 12 months %
Gold Mining	52.3	Drug Chains 54.1
Oil Exploration & Production	23.9	Broadcasting 49.7
Natural Gas	18.3	Drugs 49.2
Food Wholesalers	16.7	Long-Dist. Telecomm. 42.3
Defense Electronics	16.4	Food Chains 39.2

WORST-PERFORMING GROUPS

	Last month %	Last 12 months %
Machine Tools	-24.0	Oil & Gas Drilling -60.8
Invest. Banking/Brkrge.	-23.2	Leisure Time -51.9
Toys	-18.7	Metals -49.7
Metal & Glass Containers	-17.6	Machine Tools -42.7
Department Stores	-15.0	Transportation Svcs. -40.8

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness

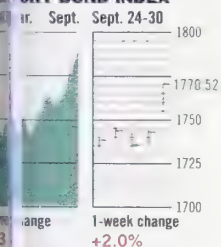
	Price	1-month change
Citicorp	97 3/4	-10 9/16
BankAmerica	62 1/4	-2 1/4
Procter & Gamble	72 1/16	-4 1/16
Eastman Kodak	77 15/16	-3 1/16
Xerox	87 1/2	-5 1/16
Merrill Lynch	50 7/8	-15 7/8

Decline ahead? Stocks with most significant selling on price strength

	Price	1-month change
Dell Computer	67 13/16	17 13/16
Cisco Systems	64 7/8	10 9/16
MCI Worldcom	50 9/16	9 5/8
Microsoft	112 7/8	16 15/16
Tellabs	44 7/8	2 3/8
PeopleSoft	33 1/16	5 9/16

INTEREST RATES

TREASURY BOND INDEX



KEY RATES

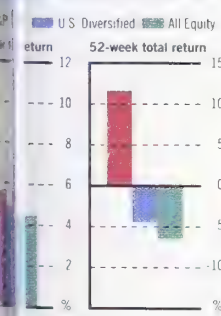
	Latest week	Week ago	Year ago
MONEY MARKET FUNDS	5.05	5.06	5.14
90-DAY TREASURY BILLS	4.36	4.68	5.10
6-MONTH BANK CDS	4.82	4.86	5.19
1-YEAR TREASURY BILLS	4.39	4.59	5.44
10-YEAR TREASURY NOTES	4.42	4.67	6.04
30-YEAR TREASURY BONDS	4.97	5.17	6.33
LONG-TERM AA INDUSTRIALS	6.03	6.17	6.78
LONG-TERM BBB INDUSTRIALS	6.79	7.04	7.17
LONG-TERM AA TELEPHONES	6.45	6.60	7.11

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond Latest week	Last week	30-yr. bond Latest week	Last week
GENERAL OBLIGATIONS	4.14%	4.16%	4.78%	4.83%
PERCENT OF TREASURIES	93.67	89.16	96.04	93.45
TAXABLE EQUIVALENT	6.00	6.03	6.93	7.00
INSURED REVENUE BONDS	4.29	4.33	4.97	5.03
PERCENT OF TREASURIES	97.36	92.81	100.06	97.32
TAXABLE EQUIVALENT	6.22	6.28	7.20	7.29

MUTUAL FUNDS



EQUITY FUNDS

Leaders	40-week total return %	Laggards	40-week total return %
Pioneer Gold A	46.5	Potomac OTC/Short	-13.2
Fidelity Select Gold	46.3	ProFunds UltraBear Serv.	-11.8
Am. Cent. Global Gold	45.3	Lexington Troika Russia	-9.8
Fidelity Sel. Prec. Metals	44.5	Kemper Europe B	-7.5
USAA Gold	44.2	Weitz Hickory	-7.1
Leaders	52-week total return %	Laggards	52-week total return %
Smith Barney Telecomm. Inc.	48.8	Lexington Troika Russia	-88.8
Flag Investors Commun. A	35.7	Guinness Flgt. Asia Sm. Cap	-63.8
Janus Twenty	35.6	Matthews Korea I	-62.6
Icon Telecomms. & Utilities	34.5	Frontier Equity	-62.4
Fidelity Sel. Health Care	33.0	Lex. Crosby Sm. Cap Asia	-61.6

EQUITY FUND CATEGORIES

Leaders	40-week total return %	Laggards	40-week total return %
Precious Metals	36.3	Japan	-2.6
Natural Resources	15.6	Europe	-2.6
Pacific/Asia ex-Japan	12.5	Foreign	-0.7
Health	10.7	World	1.5
Technology	9.6	International Hybrid	1.7
Leaders	52-week total return %	Laggards	52-week total return %
Utilities	18.9	Pacific/Asia ex-Japan	-49.0
Communications	13.9	Latin America	-47.9
Large-cap Growth	8.6	Diversified Emerging Mkts.	-45.8
Large-cap Blend	5.3	Diversified Pacific/Asia	-39.2
Health	4.2	Precious Metals	-32.1

NEEDED: A NEW FINANCIAL ARCHITECTURE

Nations live by their polite fictions as much as individuals do, but the current international financial crisis requires a brutal honesty that so far has been lacking. A deflationary spiral, triggered by powerful monetary forces, is threatening to send the world into a severe economic recession. Federal Reserve Board Chairman Alan Greenspan's modest move to cut interest rates is a step toward restoring liquidity to the global economy. But a more fundamental restructuring of the architecture of international finance is needed.

The truth is that a crisis that revealed deep underlying flaws in Asia's financial system is now uncovering similar problems in the U.S. Europe may soon follow. The best and the brightest minds of our day have made serious errors in judgment and policy. The institutions we rely on to facilitate the international flow of capital are deeply flawed. The capital markets themselves have been defective, warped by an unwillingness to properly evaluate and price risk.

The failure of Long-Term Capital Management, one of Wall Street's best-connected hedge funds, reveals the price of miscalculating risk. The Fed has a public obligation to explain how it failed to see that bank loans to LTCM were fueling an unprecedented leveraging of capital that threatened the entire financial system. Why was a market solution to the problem, in the form of an offer to buy LTCM led by Warren Buffett, rejected? How can the outrageous personal and professional conflicts of interest in the LTCM bailout be justified? The Fed-brokered bailout of LTCM shows the sheer hypocrisy of America lecturing Asia about crony capitalism while apparently practicing it at home.

TIME FOR A GLOBAL DEBT WORKOUT

The debate over creating a new financial structure for the world begins and ends with the issue of risk. It is now clear that the global financial crisis began because capital markets didn't price risk correctly. To many Asian bankers, risk wasn't even an issue. Connections to politicians, friends, or family members determined capital flows. But American and European bankers, who are supposed to be trained in the art of evaluating risk, wound up doing a wretched job as well. And not only in Asia. LTCM is based in Greenwich, Conn.

What must be done now? Large-scale reliquefaction of global capital markets is critical. The Fed must ease further, but move cautiously. The terrible credit crunch that is strangling growth in Asia is beginning to squeeze out the speculative froth in the U.S. That's good, but credit could quickly dry up, even for solid U.S. borrowers. It would help if the new European Central Bank moved out of its Eurocentric box and began to lower rates as well.

A global workout is the next step. A huge debt overhang is crushing Asia, Russia, and Latin America. Banks that miscalculated the risk in lending must take the lead in returning regions to growth. Securitizing the debt, swapping it for Brady-type bonds and other workout mechanisms, can ease the

overhang problem. Asia's debt problem, unlike Latin America in the 1980's, is a private matter. Excessive bank lending to businesses triggered the crisis. Mistakes were made on both sides. Both should work it out.

Pumping in Export-Import Bank loans would help in one way. Asia is starved for export financing. Asian companies import most of their parts from the developed world and re-export assembled products to the U.S. and elsewhere. U.S., Japanese, and European ExIm banks should extend massive loans to help liquefy Corporate Asia.

SOME GOVERNMENT IS ESSENTIAL

Expanding government oversight is critical, too. The notion that free markets exist in a vacuum has been shattered. Without rules and regulations, they can create anarchy. Enforced accountability and transparency is government's job. This is true for the U.S. as for Asia. In Asia, far greater disclosure is needed of usable bank reserves, forward liabilities of corporations, and foreign-currency liabilities of commercial banks. In the U.S., data on derivatives and other off-balance-sheet financing must be made available for oversight.

U.S. hedge funds go entirely unregulated. At the very least, they must reveal their positions, indicating leverage, to regulators, as mutual funds already do. Congress made a mistake in allowing hedge funds to go unregulated, in passing legislation that allowed exponential growth in their financial leverage and power. The failure to supervise the derivatives and loan industry in the 1980s and the disaster that followed should have cued them to supervise hedge funds.

U.S. Treasury Dept. and IMF policy must change as well. Forcing Asian governments to raise interest rates and cut public spending, when the problem lay in short-term private corporate borrowing, proved immensely destructive. Austerity is not the solution. A debt workout between the banks and corporations is the answer. Imprudent banks and overambitious companies should take the haircut—not those pushed into poverty. Congressional conservatives are right in insisting that the IMF end its obsession with high interest rates, austerity, and austerity. If it does, it again deserves U.S. funds.

Finally, temporary capital controls should be considered to prevent the excessive build-up of short-term foreign-currency liabilities. Switzerland had a negative interest rate on foreign-currency deposits for years. Chile has used controls on short-term capital effectively. Permanent capital controls lead to corruption, the misallocation of capital, and the stalling of economic growth. But free-market economists, such as World Bank Chief Economist Joseph E. Stiglitz, believe that they can be temporary salves for a deeply wounded global economy.

There is no time left for defensive justifications and relative rationalizations. The Asian crisis is at America's doorstep. It has revealed deep flaws in the global financial markets—in risk assessment, leverage, and oversight. It is time to construct a better financial system.

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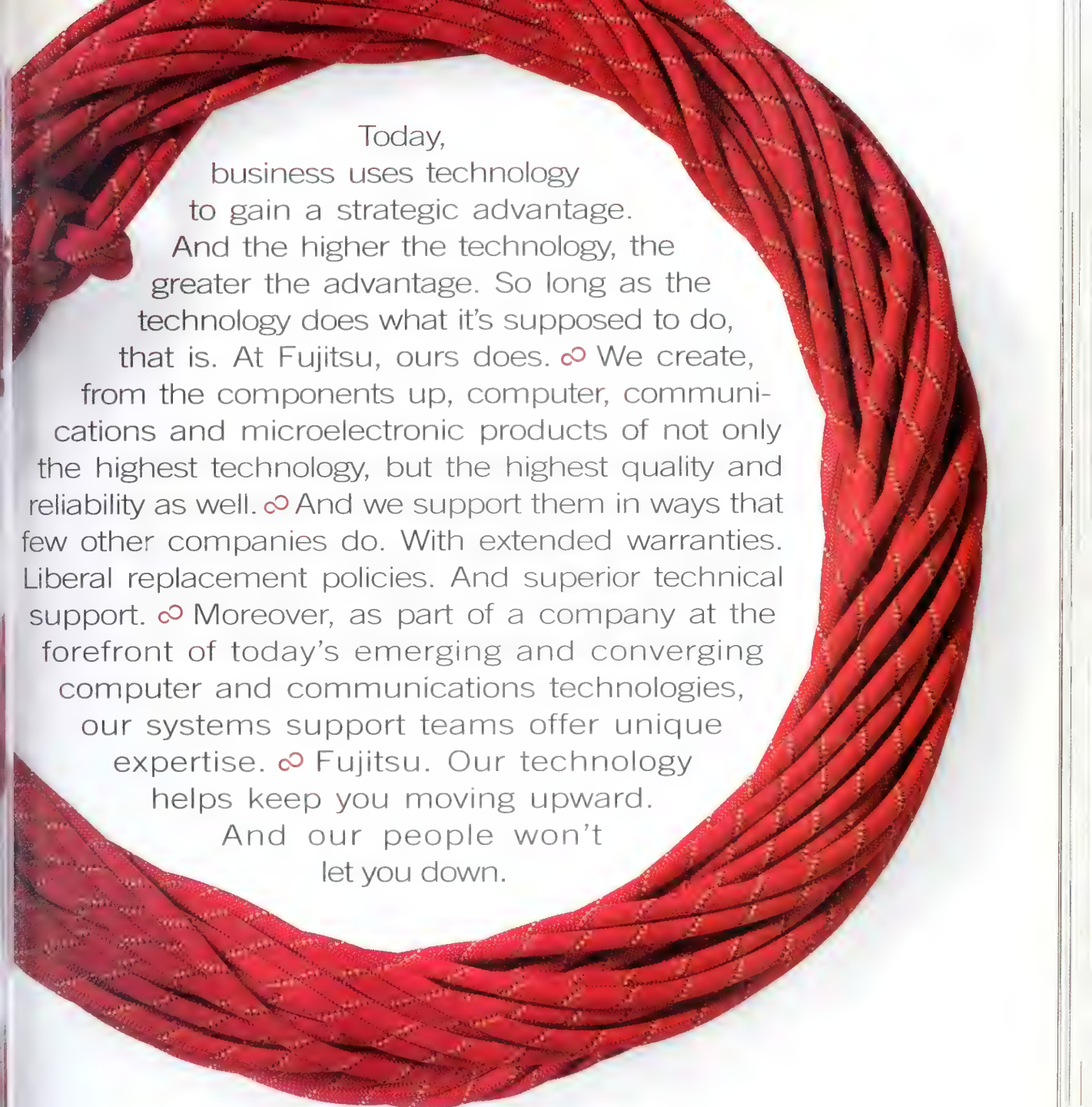
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SPECIAL REPORT

THE BEST B-SCHOOLS

At Wharton, they're chanting "We're No. 1"—for the third straight time. Here's how BW's biannual survey shakes out
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PLUS: A Personal Business guide to your MBA—from choosing a B-school to hiring an admissions adviser
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BusinessWeek

OCTOBER 19, 1998

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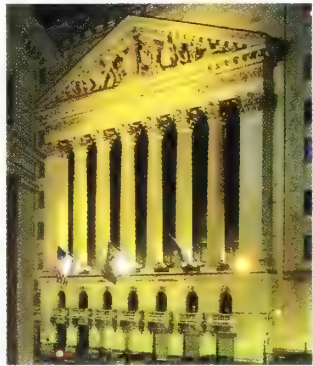


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Up Front

EDITED BY ROBERT McNATT

THE DEAL MILL

MORE CONDENSING AT THE DIGEST?



THE HEAT IS ON THOMAS RYDER, new CEO of the Reader's Digest Assn., to quickly bring about a turnaround in the sagging fortunes of the venerable publisher, based in Pleasantville, N.Y. According to sources close to Time Warner, one change now being considered is a spin-off of Reader's Digest's direct-marketing operations into a joint venture between the two companies.

The direct marketing of books, music, and videos is a far bigger part of Reader's Digest's business than its namesake magazine. And direct-marketing sales of \$1.6 billion were down 11% from

1997 in the year ended June 30, while the division's operating profits sank 58%, partly reflecting increased promotional costs.

The contemplated alliance could provide some help fast. Time Warner is already planning to launch a new World Wide Web retailing effort for Time Life books and videos, the



RYDER: Pressure

Book-Of-The-Month Club, and the company's other direct-sales units.

Time Warner Chairman Gerald Levin has said that his company has the customer service and product fulfillment operations that other Web sellers lack.

Time Warner already has 250 Web sites through which it could promote its wares. Both Reader's Digest and Time Warner declined comment on any joint venture. *Richard Siklos*

MEDIA MANIA

STAY TUNED FOR NICHE RADIO

MOVE OVER, HOWARD STERN. XM Satellite Radio is bringing niche programming to the radio business. Although the Washington-based company won't broadcast anything until 2000, it's already targeting its audience.

You can't yet hear the shows in the XM lineup, due to be announced in October, because as yet XM is a satellite broadcaster without satellites. But once they are launched, in 1999, XM will be able to blanket the nation, unlike a typical AM or FM station.

XM plans to take advantage of this national audience by

offering what local stations usually can't support. "Our plan is to launch a service that will do to radio what cable TV did to broadcast," says CEO Hugh Panero. Expect the first national Mandarin and Hindi radio programs, three new Christian channels, five Hispanic music stations, as well as C-SPAN and *USA Today*. Radios that pick up the signals will cost about \$300.

Traditional broadcasters are skeptical of the technology, though XM has one rival, CD Radio, also ready to launch in 2000. But XM plans to make money by selling ads, and will price the service itself at \$9.95 monthly. Backed by Hughes Communications Satellite Services, it expects profits by 2003. *Catherine Yang*



TALK SHOW "I've never seen anything like this. This is really quite an unusual phenomenon"

—Alan Greenspan, commenting on market conditions before a business group

SOFTWARE HARBALL

MICROSOFT CALLS THE PLUMBER

MICROSOFT CORP. IS GETTING tough with what it says are illegal leaks from E-mail and other documents under court seal in lawsuits against it. On Oct. 6, the software giant took its most aggressive step yet against leaks

by serving Dan Goodin, a reporter for the C/Net online news service, with a subpoena. Microsoft demanded that he turn over materi-

als referred to in two recent stories published on Sept. 23, one of which describes Microsoft's heavy-handed tactics in a "holy war on Java." Goodin declined comment. But C/Net attorney Kent Raygor, of the Los Angeles law firm of Sheppard Mullin Richter & Hampton, says California's strong shield law will protect Goodin from be-

ing found in contempt of court for refusing to disclose information used in publishing the stories. "It looks like they're trying to find out where the leaks are coming from," says Raygor.

A Microsoft spokesman, Mark Murray, says the company isn't trying to find the leaks, but just wants the documents back. "This is information that



was designated as confidential by a court protective order," he says. The material was from a Sun Microsystems suit accusing Microsoft of violating the terms of a Java programming language licensing agreement, Murray says. This is the third time this year Microsoft has taken legal action to combat unfavorable leaks. *Steve Ham*

TELECOM TALES

AT&T'S DOG HAS A NASTY BITE



THERE'S A NEW DOG PLAYING some old nasty tricks. AT&T's new Lucky Dog phone service is offering the supposedly bargain-basement rate of 10¢ a minute plus a 10¢ connection fee for customers who dial seven extra digits before making a long-distance call.

But wait a minute. Competitors Sprint and MCI WorldCom already offer a 10¢ rate—and you don't pay any

extra connection fee. Even AT&T already has a 10¢ per-minute rate, though it charges some customers \$4.95 a month for the program.

Think of all that brief, one-minute calls you make. With not-so-Lucky Dog, you'll pay 20¢, or twice the best rate at AT&T, Sprint, and MCI.

So why is AT&T pulling this plan, known as a dial-around? Because it's getting killed by other dial-arounds, notably MCI's 1-321—which can also be wily expensive. Daytime rates for calls of less than 20 minutes are a sky-high 28¢ a minute. That dial-around numbers are often rip-offs, says industry consultant Jeffrey Kagan, "the best-kept secret in long distance." But the companies say that certain customers may still benefit from the dial-arounds. *Peter Elstrom*

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SHOW BIZ

DOES THIS MAN HAVE HIS ACT TOGETHER?

DAVID COPPERFIELD MAY BE a master of illusion, but harsh reality has seriously delayed plans for his extravagant new \$30 million restaurant and interactive entertainment center in New York City's Times Square.

The problem? The developer ran out of money because of construction delays blamed on some of the elaborate illusions planned for the complex. In one of them, for instance, a box full of customers disappears. Although the trick is a showstopper, it also became apparent that major changes in seating and design were needed to keep customers



COPPERFIELD

from seeing how it's done. With no payment, subcontractors slapped \$15 million in liens on the project, setting back the opening of Copperfield Magic Underground, at 49th Street and Broadway in Manhattan, to March.

That's 10 months behind schedule. The problems have also delayed construction of a similar Copperfield facility in Orlando. "We took a hiatus to raise additional funds," says developer Glen Tullman of LateNite Magic in Libertyville, Ill.

He's putting the project together for Copperfield, Walt Disney Co., and their fellow investors. Tullman said that with the additional funding—he refuses to divulge the source—liens from 25 contractors have been settled. *Dennis Blank*



MAIZE MAZE:
Learning tool

in families and fans of hot computer maze games such as *Riven* and *Myst*.

The mazes are also proving

popular for corporate team building. At Frantz's maze in Lambertville, Pa., managers from M&M Mars, Bristol-Myers Squibb, and Toys 'R' Us, among others, are seeking wisdom in the maze. "The sense of the maze is about getting lost and found," Frantz explains, "so it's the perfect metaphor for the arc of accomplishing a task."

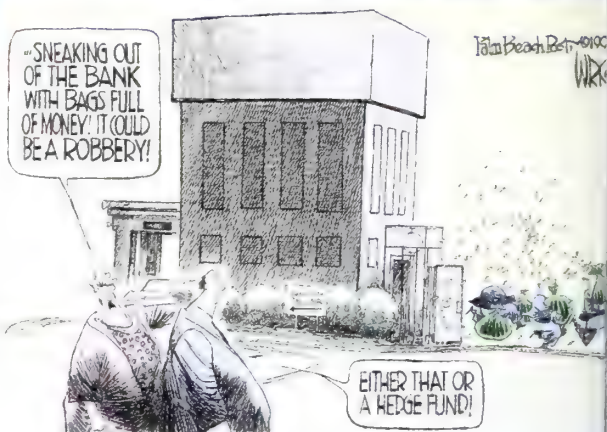
Leaders emerge, and competition, squabbling, and other hallmarks of business decisions arise as teams wander through acres of corn stalks, seeking hidden clues to the way out. But hurry. The fun ends when all the corn gets harvested shortly after Halloween. *Joan Oleck*

EXECUTIVE TRAINING

FEEL LIKE A RAT IN A MAZE—AND ENJOY IT

DONALD FRANTZ, WHO helped produce the hit stage versions of *Beauty and the Beast* and *The Lion King*, is going about as far from Broadway as you can get. He is designing and promoting corn mazes. The six mazes, each two to six acres in size, are in Iowa, Pennsylvania, New Jersey, New York, and North Carolina. Frantz expects his company, American Maze, to gross \$748,000 this year in an emerging industry he calls "agritourism." He sees potential

DRAWN & QUARTERED



OVER THERE

THE EC SURE FAILED THIS TEST

THE BUREAUCRATS AT THE European Commission have been badly embarrassed because they didn't know what any high school teacher could have told them: When hordes of test takers leave a room during an exam to "use the facilities," trouble's afoot.

Specifically, the trouble was mass cheating, carried on at some of the 37 sites where tests were being given for elite EC jobs paying \$50,000 and up. When Alexandra Ruete, a German market researcher, took the test in

Brussels in September, noticed something odd. "My applicants kept going to the toilet," she recalls. She wondered why, only to find later that some had gotten advance test copies and were swapping answers in the bathrooms. At some sites, applicants reportedly even took the test in the room and used mobile phones to call for help.

In the wake of the fiasco, the EC is instituting new security measures and is notifying all 25,000 applicants regarding the exam. But even for those who pass, jobs are not guaranteed. The test of EC mirage is just the start of a 18-month selection process that ends with only 400 offers. *William Echik*

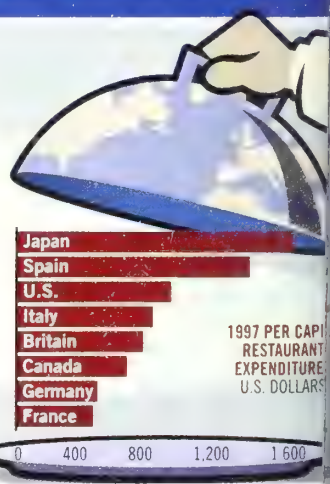


THE BIG PICTURE

DINERS OF THE WORLD, UNITE

The Japanese and Spanish, per capita, spend a lot more eating out than we do. One theory why: the omnipresence of fast food in the U.S. may mean smaller tabs for eating out.

DATA: EUROMONITOR INTERNATIONAL



FOOTNOTES Americans who think big companies are guilty if investigated by the government, 57%; if targeted by a lawsuit, 97%

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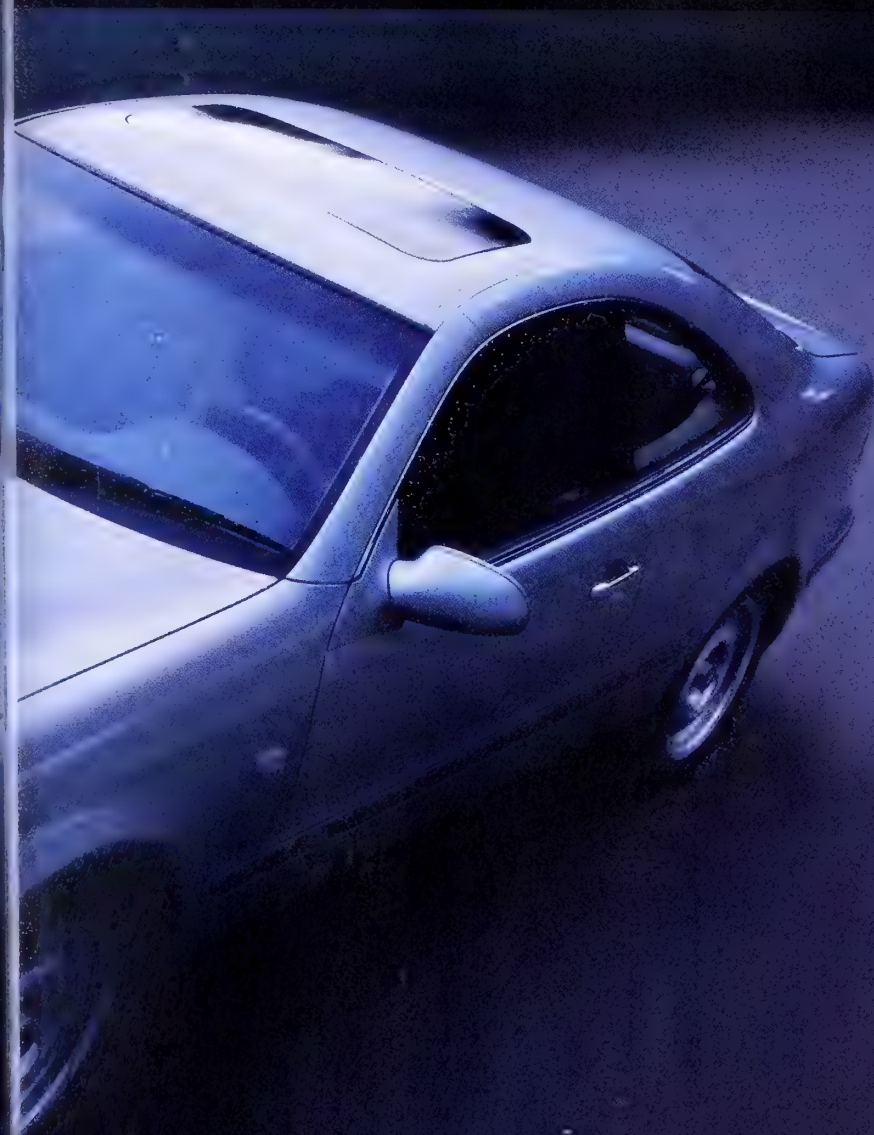
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wer to remove the President from ice if he is found guilty of treason, iberly, or other high crimes and mis-meanors. I think the founders knew it if the President is allowed to es- se the proper punishment for even a nor crime, then an ever-widening gap l grow in which the President can above the law.

Finally, people are often like the ld with a toothache: The child wants hot of painkiller and doesn't want n from the drilling and filling neces- sity to cure the toothache. Our leaders st educate the people that we need proper solution to the problem and avoid the less painful but tempo- y fix.

J. R. Moody
Hudson, Ohio

GLOBALIZATION: AN IDEA WHOSE TIME HAS PASSED

n my opinion, the cardinal lesson in ssions from the brink" (Editorials, t. 21) should be that it is time to re- se the process of globalization. It is planting diverse national economies h a single global economy. That uld be the economic equivalent of inating genetic diversity in the en- nment. In the end, we would be left n a global economic "monoculture." Unfortunately, a monoculture can be as inferior and harmful economi- y as it can be environmentally. he booming U.S. economy amid a al recession illustrates the point. pite all its free trade braggadocio, U.S. imports only 12% of gross estic product. We in Canada im- 29%, mostly manufactured goods could easily make ourselves. Not rprisingly, our unemployment rate is ificantly higher and the GDP per tal is significantly lower than in U.S.

ational governments are, of course, responsible for the economic well- g of their countries. In the past, national governments of developed tries could use import tariffs to ire that enough private capital ed home to maintain employment living standards. Global free trade ripping those governments of the s with which they could induce cap- to behave in the national interest. onically, global free trade is an idea se time is passing. Science and tech- y have been increasing productivi- xponentially. The resulting steady ne in production breakeven points ld keep even smaller national omies viable.

Joseph Z. Bako
Vancouver

COULD BILL FORD BE BOSS ANYWHERE BESIDES FORD?

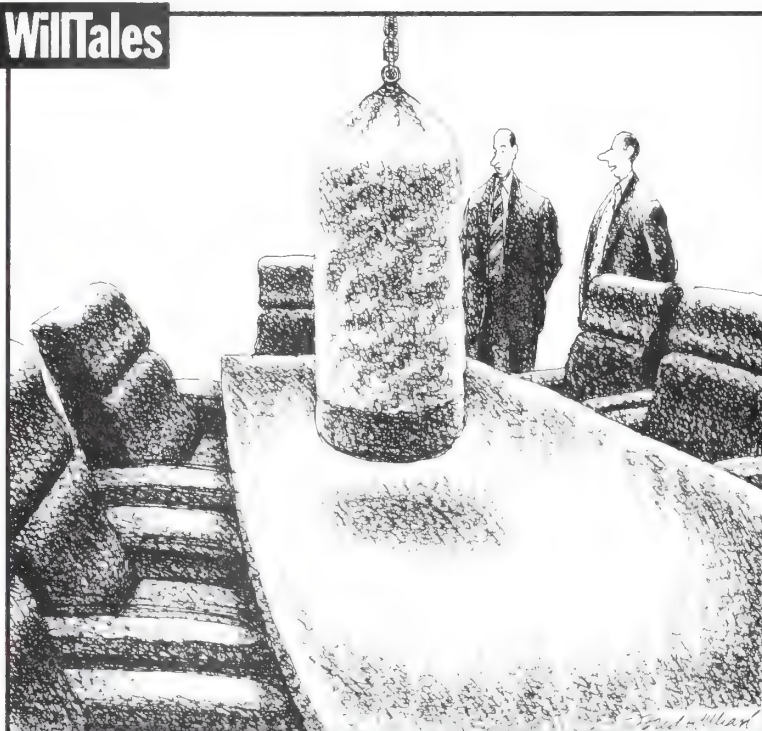
The appointment of Bill Ford Jr. as chairman of Ford Motor Co. is another example of why I'm disgusted with Corporate America ("Chairman Ford," Cover Story, Sept. 28). He's wealthy, Princeton-educated, and he owns a foot- ball team. A board member at 30? How many board members of big companies are 30 and earned it? However difficult it was to be "under the microscope,"

most people in America will never have the chance to get where Bill Ford is, no matter how well-educated or how hard they work. The same goes for Christopher B. Galvin of Motorola Inc. It sickens me to see opportunities like this go to people who grow up so rich and privileged.

I'd like to see Bill Ford start a com- pany with only a little or no money or try to get the chairman slot at some other company without being famous. It's easy to embrace "social engineer-

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Readers Report

CORRECTIONS & CLARIFICATIONS

The table for "What the NASD rap sheets don't tell you" (Personal Business, Oct. 5) incorrectly identified the National Registry of Financial Service Representatives.

In "No excuses not to go to Minneapolis" (Up Front, Sept. 21), the number of Sun Country Airlines scheduled flights was misstated. It's 100 per week.

ing" when you are not hurt by paying for it. And about being a "passionate environmentalist," let's see if he'll reduce the exhaust level by flying coach instead of one of Ford's Gulfstreams or Learjets.

Robert Decarolis
Colts Neck, N.J.

DON'T LET THE PROFIT MOTIVE SCUTTLE A USEFUL MEDICINE

As one who has a family member suffering from chronic fatigue syndrome, I wish to protest "Why Hemispherx could take sick" ("Inside Wall Street," Sept. 28). Ampligen appears to be one of the few drugs that improve the quality of life for these patients, and it would be a shame if the company's ability to produce this were curtailed because it was not considered a "good investment."

Joan M. Swendsen
San Francisco

AS STARBUCKS AIMS HIGHER, OTHERS MAY BREW BETTER

I read "Reheating Starbucks" (The Corporation, Sept. 28) with some amusement. Over the years, Starbucks Coffee Co. has tried to dominate the market in any way it could, to the detriment of locally owned coffeehouses in many parts of the country. Its predatory practices are well-known. It's the abandonment of the core values on which the company was founded and the attempts to use the Starbucks name to foray into non-coffee-related areas that makes Starbucks no longer a purveyor of specialty coffee. It has over the years become just another brand name.

As Starbucks tries to get the most mileage out of its name and continues trying to get into everything from supermarkets to discount clubs, it opens up the opportunity for companies like ours to reestablish what specialty coffee is all about, serving a great cup of micro-roasted coffee at a reasonable price.

The slowdown in its comparable-store sales is evidence of a growing number of people finding out that they can get a better cup of coffee elsewhere.

Srini Anne
Senior Partner
Conga Coffee & Tea Co.
Mount Clemens, Mich.

COMPUTER-USER ACTIVISTS IGNORE STANDARDS, COSTS

"A computer user's manifesto" (Technology & You, Sept. 28) proposes a user's bill of rights to remedy the ills of the computer market. Sadly, I don't think it will work. Users have demonstrated for two decades that they favor "computability" and low cost to a superior user experience. Apple Computer Inc. and thousands of tech journalists can testify to that.

Users need much more than a responsive complaints mechanism. They need independent standards for usability and computability to get the right decisions made at the design stage. In all industries, vendors build products to deliver specs that are often meaningless. Usability needs an index (with a catchy marketing name) that can be objectively measured and reported. For far too long, monopolistic vendors have captured user data in proprietary formats and held it for ransom. Computability requires that users develop and own open standards for their data. It's time for an organized, standardized users' revolt.

Ian R. Cheong
Brisbane, Australia

Clare-Marie Karat wants to promote her "user's bill of rights"—I wonder if she is willing to pay the price. Ever since software became a consumer good, publishers have recognized the trade-off between quality and price. You want bug-free software? Fine, but be prepared to go back to the days when a simple word-processing program cost \$400 or so. Statements like "the user is always right" do little more than inflame. They most assuredly do not recognize the costs associated with attempting to make every user very happy with your product.

Tony Lima
Hayward, Calif.

MARRIED MEN EARN MORE—THEY HAVE NO OTHER CHOICE

The study by Donna Ginther and Madeline Zavodny on why married men appear to earn more than their peers is

interesting but seems to not go after the more detailed, more important issues ("To have, to hold, to prosper" Economic Trends, Sept. 21). It seems reasonable that married men will earn more based on the need to do well economically. With new financial commitments (wife and possibly children), the man will not only have to support himself but others as well. This "extra burden" will be the impetus to earn more.

This sense of obligation is sure to cause a person to be more focused on activities that earn money—and with more time constraints, as a result of family obligations. I would reason that marriage helps to stimulate additional responsibility and maturity in men such that they concentrate on being productive.

Michael Grute
San Francisco

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Horizons

The size and scope of the changes in the German standard services telecom market since Deregulation Day on January 1, 1998 have been of a scale going far beyond even the most optimistic of forecasts.

Virtually all of the 23 companies now contending for business with mighty Deutsche Telekom AG, the country's former monopoly in the sector, report strongly rising turnovers, their ever-sharper waves of price-cutting notwithstanding. The newcomers now hold 6% of the standard services market, whose average prices are now 60% lower than they were a year ago.

Not that Telekom is suffering. It recently reported strong annual profits and a further rise in revenues. Lower prices have been more than counterbalanced by the tremendous increase in the number of telephone calls made. Germany's telecom services market had revenues of DM 100 billion in 1997. Accounting for 25% of the EU's total, Germany is the third-largest telecom market in the world.

Role Model

This growth is being produced in all sectors of the market, not just by standard telephony, points out Barbara Kögler, spokesperson for Arcor, one of Telekom's chief rivals. "The German telecommunications market is the very role model of a fast-growing one."

Headquartered in Frankfurt, the Hoesmann-led Arcor is one of the companies making the State of Hessen an epicenter of German

telecoms' "Big Bang". Other telecom powers setting up shop in the city include WorldCom, based in Frankfurt since 1995. The American communications giant now operates a "metropolitan area network" in the city. This grid exhibits the speed of access and

gateway, located in Hessen and the second largest in the country. Also in Hessen is the DE-CIX, Europe's second-largest relay point for Internet-based transmissions, plus a wide range of other technical systems and facilities.

clude CCC (computer communication connectivity) systems, telecommunications management services and wireless broadband access products. Hessen is, once more, a hub for supplying such leading edge products and services. These are provided by

Hessen is at the heart of Germany's fast-growing telecoms market

volume of capacity required by its main customers – Frankfurt's financial community, the largest in continental Europe. WorldCom does not have this market to itself. The American-owned Colt and Deutsche Telekom operate competing networks.

Frankfurt is the hub

These and other high-volume telecommunications links are also used by the burgeoning number of non-German ICT multinationals based in Frankfurt.

The multinationals' ranks include leading network operators – AT&T, British Telecom, Cable & Wireless, France Telecom and Sprint – plus major suppliers of equipment, devices and computer systems such as Ericsson, Alcatel SEL and IBM.

Proximity is one factor inducing the rise of this ICT cluster, which also includes T-Online, Europe's largest provider of online access. All of the telephone calls made to and from Germany pass through Deutsche Telekom's satellite

Focus on Hessen

The multinationals have flocked to supply their products and services to and profit from Hessen's communications hub. Today, the Rhine-Main region, centered in Frankfurt, is home to Germany's greatest agglomeration – on a relative basis – of software companies. Many of their products are used by the multinational network operators to facilitate the transmission and processing of data, and specifically images.

Plenty of Room

Despite the numerous new arrivals, "there's still plenty of room for further international companies in Germany's telecoms market," points out Stefan Hischer, managing director of WorldCom Germany. He adds: "In fact, the market has really only just started to develop." The opportunities for foreign investors are still virtually unlimited. Areas of demand now emerging on Germany's telecoms market in-

clude Ascend (based in Weiterstadt), Bright Voice (Wiesbaden), Nitro Corporation (Eschborn) and other American corporations, as well as by a wide range of other non-German and German companies.

Hessen, centrally positioned in Europe, is one of Germany's most dynamic federal states with a thriving diversified economy which includes the country's financial capital Frankfurt. In fact, Hessen is among Germany's leading federal states in attracting foreign direct investment.

"Horizons" is published by HLT, the Economic Development Agency of the German federal state of Hessen, to provide U.S. companies and their managers with regular information about the economic, corporate and political environment in Germany. To find out more about investment opportunities in Hessen, please contact:

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Commentators have marveled how some of the best-managed banks in the U.S. and Europe, and the best minds on Wall Street, could have suffered such disastrous losses from investments in Asia, Russia, and elsewhere. These losses reveal not only that there are few free lunches available to investors but that it may be difficult even for the smartest to distinguish great opportunities from risky strategies.

The theory of efficient markets states that all known information is priced into equities, derivatives, and other securities, so that if some investments yield greater than normal returns, they also bear correspondingly greater risks. This is the best theory available for understanding the way assets are priced, but it is a very imperfect one. There have been many exceptions, called "anomalies," where investment strategies for a while have yielded exceptional returns without exceptional risk.

The simplest example of such an anomaly is when the price of the same stock is, say, higher in London than in New York, so that easy arbitrage profits can be made by buying shares in New York and selling them in London. But pure arbitrage opportunities are short-lived.

The problem for investors is to distinguish truly excellent investment opportunities from strategies that yield high returns because of sizable underlying risks. This is often extremely difficult, especially when the risk is only a tiny probability of large losses. The losses would then be infrequent, but they would be whoppers when they occur.

SECRETIVE. I believe this explains why so many top banks and financial institutions were eager to invest large sums in Long-Term Capital Management, the hedge fund run by several of Wall Street's savviest traders, including two who received the Nobel prize for their pioneering contributions to the theory of option pricing. So much money was eagerly made available to this fund that the partners returned a couple of billion dollars because they felt there were not enough good investment opportunities.

LTCM began in 1994, and the annual returns were extraordinary until the recent debacle: 43% on equity in 1995, and 41% in 1996. LTCM was secretive about its investment strategies, partly because it did not want them copied by others. So investors could not tell whether

the remarkable performance was due to the discovery of a new way to take advantage of low-risk opportunities or whether it required taking risks on models of market behavior that might bring disaster.

The leading partners had always indicated to me that they were not simply involved in arbitrage and hedging activities and that their investments were partly based on imperfect models of determining interest rates and other prices. The remarkable performance of LTCM tended to turn aside concern about the size of the risk. So money poured in.

A similar situation explains the huge losses incurred by many banks and other financial institutions in Russia and other emerging markets. The payoffs were generally fantastic while the good times lasted. Here, too, investors could not easily tell whether they had discovered remarkably good opportunities where they could in effect "coin money" or whether they were exposing themselves to considerable risks.

There is now demand for greater regulatory oversight of hedge funds. But there is no reason to believe that regulators will have greater ability to assess risks than banks such as UBS, which has written down its entire exposure to LTCM of over \$500 million.

It may be that bankers and other investors get careless after several excellent years of good results, as Treasury Secretary Robert E. Rubin recently said in testimony before Congress. But is there much reason to believe that regulators, who are monitoring not their own but other people's money, are more immune to this optimism? Extensive regulation has not prevented European banks from taking a beating in Russia or American commercial banks, like Citibank, from almost going bankrupt from disastrous Latin American loans in the 1980s.

No, greater regulation will not control greed and the eternal quest for investments that provide high returns with only modest risk. However, we can all become more immune to claims about great success by assuming as a first approximation that markets are reasonably efficient, so that high returns typically carry sizable risk. For persons unwilling to bear heavy risk, this is likely to mean missing out on a few truly exceptional investments. But it also will enable investors to avoid the disasters now rocking many financial intermediaries.



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Economic Trends

BY GENE KORETZ

THE ODDS ON A U.S. RECESSION

The yield curve says they're rising

With some 40% of the world economy already contracting, fears are growing that the U.S. itself will be dragged into recession. While most economists believe it can avoid this fate—particularly with the Federal Reserve's shift toward monetary ease—most also admit that the risks of recession have risen in recent months.

One way of assessing those risks is to relate them to the shape of the yield curve—the spread between interest rates on debt securities with different maturi-

ties. Among the most sensitive of leading economic indicators, the yield curve is normally upward-sloping, with short-term rates lower than long-term rates. An upwardly sloping curve points to expanding economic activity ahead.

When the curve flattens or inverts, on the other hand, it almost invariably signals a coming slowdown or contraction. As it happens, the slope of the curve has been dropping sharply over the past year and has recently been almost flat. Even after the Fed's recent quarter-point rate cut, virtually the entire spectrum of interest rates is now below the rate on overnight money set by the Fed.

In 1996, a study by economists at the Federal Reserve Bank of New York found that the yield curve was a far better predictor of coming recessions than a number of other leading economic variables, including stock prices and the index of leading indicators. Using data from 1960 to 1995, the researchers constructed an index of the probability of a recession occurring four quarters ahead, based on how much interest rates on 10-

year Treasuries exceed or fall below those on 3-month Treasury bills. Back in early August, this spread was positive by about 0.45 of a percentage point, indicating that the chance of a recession in a year's time was only 15% or so, according to the New York Fed study. But since then the spread has almost disappeared (chart), raising the risk of a recession in 1999 to 25%. (For the risk to exceed 50%, 10-year rates would have to fall below 3-month rates by 0.83 of a percentage point.)

While a 25% recession risk may appear small, it's noteworthy that the spread gave off exactly the same signal in late 1989, a year before the 1990 recession. Moreover, the researchers point out that the yield curve has been a lot less variable in the 1990s than in earlier decades, lessening the likelihood of strong recessionary signals.

Many economists see the odds of a downturn next year as even greater. Salomon Smith Barney puts the risk at 35%. James Glassman of Chase Securities Inc. places it at 50%. And Standard & Poor's DRI believes the chance of a recession occurring before the end of 2000 now stands at 50-50.

Indeed, at least one forecaster, David A. Levy of the Jerome Levy Economics Institute at Bard College, thinks the odds of a 1999 recession have risen to 75%.

HOW TAX CUTS AFFECT THE RICH

They don't inspire longer hours

One of the major arguments for tax cuts and low tax rates at the high end of the income scale is that they promote behavior that improves economic efficiency and fosters growth. Specifically, the lower taxes on income are, the more likely people are to work, save, and invest. Because the earnings of highly paid people in a market system reflect high relative productivity, the payoff for society from tax cuts on high incomes, it has been claimed, should be particularly large.

At least as far as work time is concerned, however, the impact of tax cuts on high-income individuals appears exaggerated, report economists Robert A. Moffitt of Johns Hopkins University and Mark Wilhelm of Indiana University-Purdue University at Indianapolis. In a new study, they examine how the work habits of high-salaried men were affected by the 1986 tax reform act. Since the act, which created two basic rates of 15%

and 28%, reduced marginal tax rates for the affluent far more than for other tax payers (the top rate was 50% prior to its passage), one might expect to find them putting in longer hours.

Yet the study, which looked at some 500 affluent working men in both 1988 and 1989, found no increase at all in the work time—even though their real take-home pay rose appreciably as a result of both the tax cut and pay hikes. And the reason seems to be that many were already working their butts off.

"Such men," the authors write, "were already working such long hours (often over 3,000 per year) that there was little remaining opportunity for response to lower taxation."

WHERE DID ALL THE DOLLARS GO?

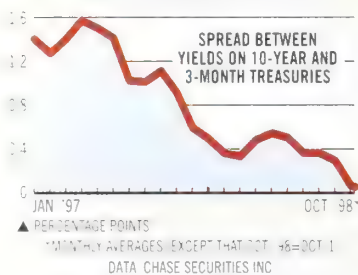
Not into the U.S. money supply

The financial markets shouldn't draw too much comfort from the fact that the M2 money supply is growing above the target range set by the Fed—although thus presumably supplying needed liquidity to the economy, warns economist Bruce Bartlett of the National Center for Policy Analysis. "A significant share of monetary growth in recent years," he notes, "is due to a sharp rise in overseas holdings of dollars."

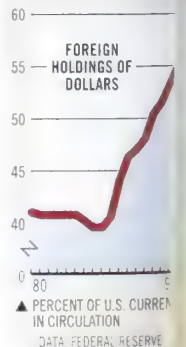
More and more dollars have been flowing overseas to troubled economies where they are used as a store of value and a medium of exchange, Bartlett notes. Indeed, according to the Fed's own estimates, the share of currency in circulation that is held overseas has risen from 40% to 55% over the past decade.

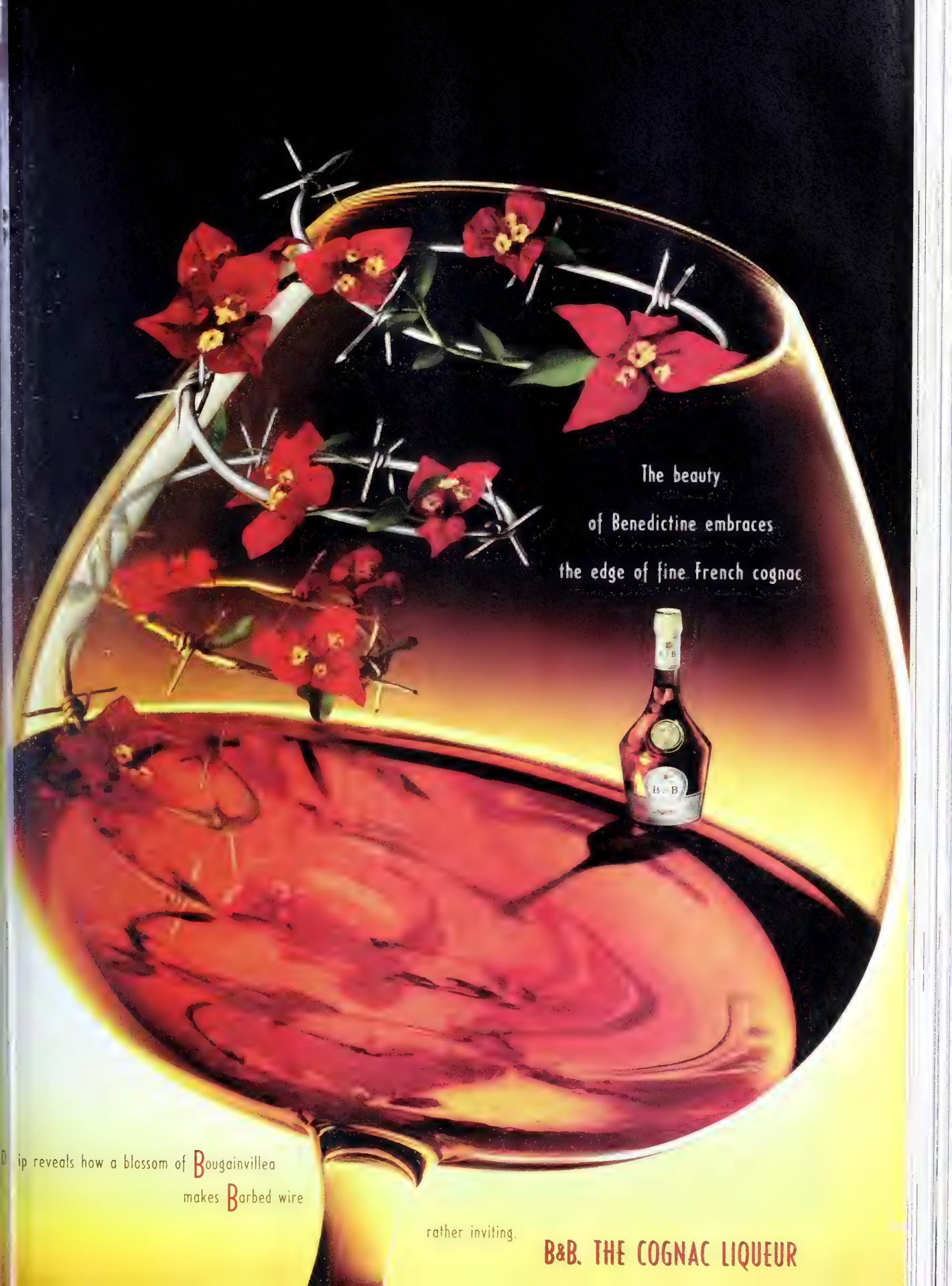
Since currency held in foreign hands isn't used for domestic transactions, it shouldn't be considered as part of the domestic money supply, argues Bartlett. Last year, he notes, the rise in foreign holdings of greenbacks accounted for about a ninth of the growth in M2. And this year, with the turmoil in overseas currency markets, the share is likely to be even larger. "Monetary growth," he says, "may be far less ample than it appears."

THE YIELD CURVE'S OMINOUS DECLINE



THOSE ROAMING GREENBACKS





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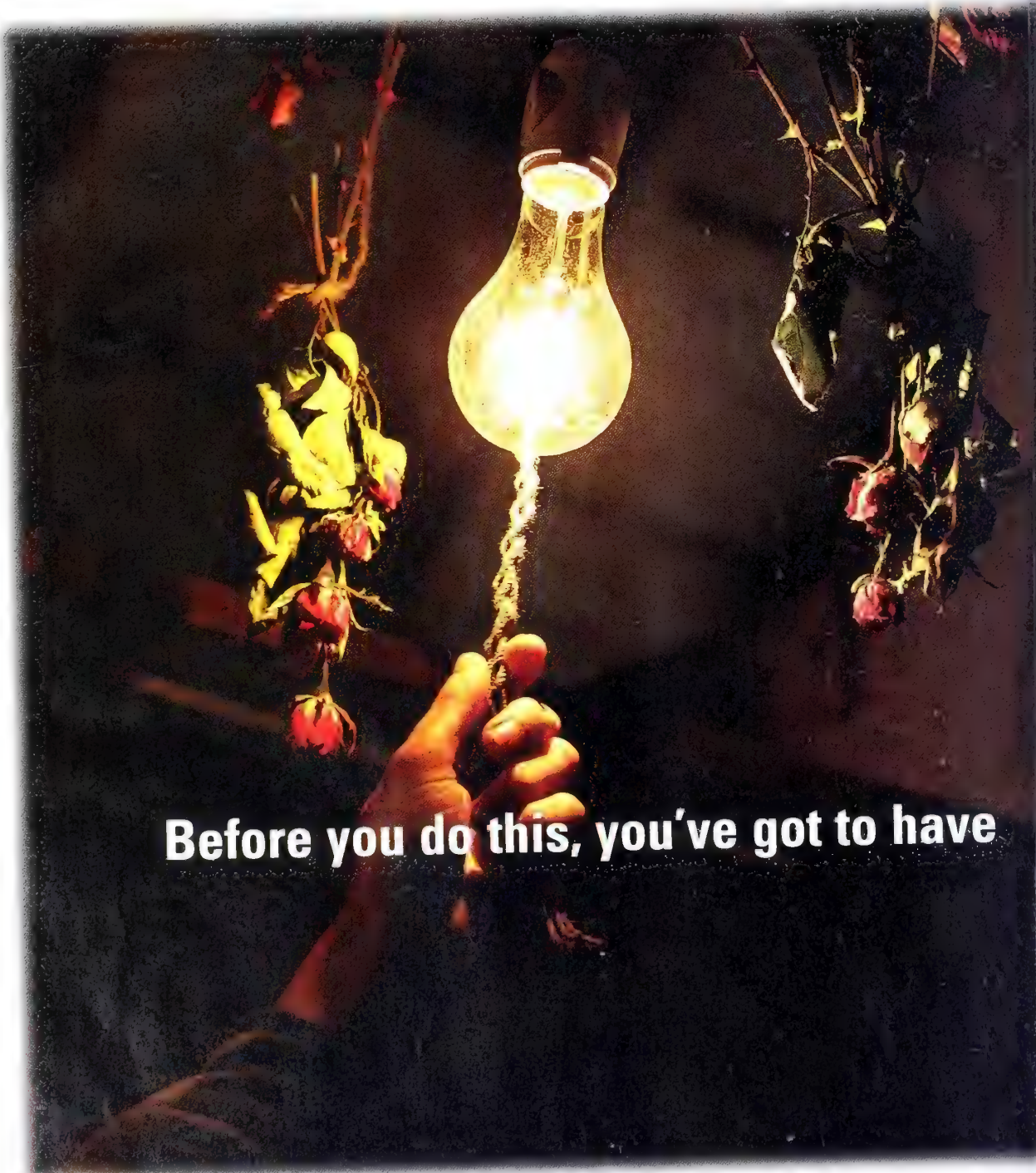


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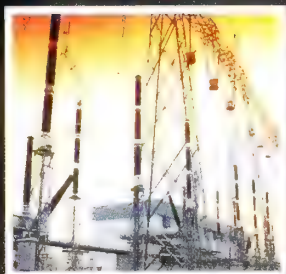
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TAKING THE MEASURE OF THE 'NEW ECONOMY'

In many ways, the term "New Economy" does not do justice to the changes going on in the U.S. and the world today. The most obvious differences between now and a few years ago include lower unemployment, an absence of inflation, startlingly low interest rates, and the amazing growth of new industries such as electronic commerce. At the same time, the increasing globalization of economic activity has brought new risks. But the changes that have produced the New Economy go beyond economics. They are also technological, political, institutional, and organizational.

Not surprisingly, then, we are seeing books that have similar titles coming at the New Economy from different angles. Like the blind men inspecting the elephant, these three volumes have all caught hold of different pieces of a very large animal. *New Rules for the New Economy* by Kevin Kelly, executive editor and one of the founding editors of *Wired* magazine, is primarily a manifesto dealing with business strategy in a networked economy. *The Weightless World* by Diane Coyle, economics editor of Britain's *The Independent*, explores how politics and government need to adapt to the new realities of technology. And *New Rules for a New Economy* by Stephen A. Herzenberg and Howard W. Alic, a consultant based in Washington, proposes some ways to change the workplace and labor markets to meet the New Economy's challenges.

Kelly's book is probably the most

provocative, but his vision is far too narrow. Not surprisingly, given his background, he starts with the basic premise that the entire global economy will turn out to be Silicon Valley and the Internet writ large. In his view, understanding networks will turn out to be the key to success. "Communication... is not just a sector of the economy," writes Kelly. "Communication is the economy."



Starting from this assumption, he lays out a set of principles—aphorisms, really—for business success. His first rule is "Embrace the Swarm," by which Kelly means companies should focus on networks and connections. Other rules include "Feed the Web First," "Opportunities before Efficiencies," and "Follow the Free." The last of these encourages businesses to achieve success by giving

products away, citing the plummeting prices of microprocessors and the way that Microsoft Corp. and Netscape Communications Corp. competed for market share by providing browsers for free.

But while the chip and the Net are important, there are big chunks of the economy—health care, education, government, financial services—that at least so far seem to work on different principles. So while it may be true on the Internet that "prices move inexorably toward the free," there is no reason to expect hospitals to start giving away health-care services, for example.

Moreover, Kelly never acknowledges that the Internet itself is still in flux and that the best business model for networks is not yet clear. Sure, companies such as Yahoo! have run up

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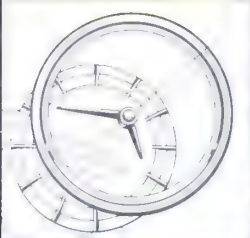
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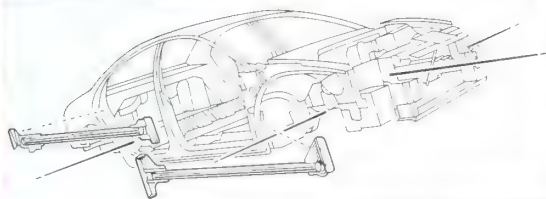


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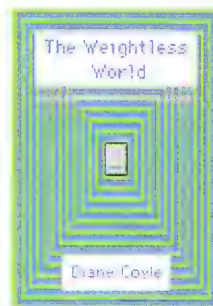
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see page 182

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stock valuations by bundling free services, from E-mail to online phone directories, but it's not obvious that this approach will make money in the long run.

Finally, Kelly's book barely mentions government, politics, or the potential for things going wrong. Kelly wholeheartedly embraces the techno-libertarian philosophy that technology can render government irrelevant. "Eventually technical standards will become as important as laws," writes Kelly. In saying this, he misses the key point that government policy provides the framework in which technology operates. Indeed, high-tech companies, long disdainful of Washington, have taken an increasing interest in policy in recent years. Kelly's exclusive focus



on technology seriously undermines the usefulness of *New Rules* as a guide to business strategy.

By contrast, Coyle pays far more attention to the political implications of the New Economy, what she calls the weightless world. She starts with a premise that Keynes might easily accept: that the economy consists increasingly of knowledge-intensive services and goods. Compared with the steel and autos that were the mainstays of the industrial economy, high-value outputs such as computer chips, software, and financial services are simply less massive—hence the title of the book.

But Coyle is less impressed with technology itself than with how it affects people and institutions. She argues that "weightless politics" requires decentralization of power and authority. "Local politicians will know more about what's happening in the economy than national leaders can gain from the official statistics and surveys," writes Coyle. As a result, "government will need to devolve power, probably to the level of cities."

Moreover, not just political power but economic activity needs to be brought down to the local level, according to Coyle. One example is local exchange-trading systems, which are basically ways of setting up a local money system in a community—in effect, an organized barter system. More than 500 of these schemes exist in Britain and Australia, notes Coyle, providing a way of jump-starting job creation without an infusion of government funds. In the U.S.

Shelley McKendry

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third period, to bring a
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one example is Ithaca, New York, which has an alternative currency called 'Ithaca Hours' that allows locals to trade for odd-job labor for other services.

Coyle is concerned with how governments can help people cope with risk. "The priority for policymakers must be to equip people better to deal with change and uncertainty," she writes. But to Coyle, that means the government should be a teacher, rather than a nanny. She would go even further with the form of the existing welfare state. What's needed instead of a dole is more investment in training and education and a more flexible system of taxation and benefits that fits the way that people really live.

Probably the weakest book of the three is *New Rules for a New Economy*.



Originally intended to be a report for the Office of Technology Assessment, before that federal agency was closed down in 1995, the book is both academic and somewhat backward-looking. Like *The Weightless World*,

it is concerned with economic anxiety and job insecurity. But there's a sense that the authors, if they could, would like to turn the clock back to an earlier era, as suggested by the title of the first chapter, "Recreating the Prosperity of the Past in the Economy of the Future." Moreover, with the Internet mentioned, the book seems dated.

Nevertheless, this book stands above the other two in its focus on changes in the workplace. One key proposal for buttressing the power of workers in a global economy is the creation of craft-type unions, which cut across companies in an industry. Current policies effectively deny representation to many workers who move among small firms, observe the authors. Still, they do not pay sufficient attention to Silicon Valley, the place where workers flow most easily between companies.

Of these three books, the one with the freshest ideas and the broadest appeal is *The Weightless World*. Yet they all have something to offer, at a time when people are trying to understand the combination of economic vigor and risk with which we live.

BY MICHAEL J. MANDEL

Economics editor Mandel won the 1998 Loeb Award for his coverage of the New Economy.

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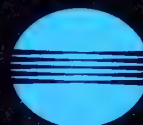
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BY STEPHEN H. WILDSTROM

THEY'RE MAD AS HELL OUT THERE

Readers the world over say high-tech designers better get customer-friendly fast

The flood of messages started as soon as my Sept. 28 column, "A Computer User's Manifesto," hit the streets. I knew that IBM researcher Clare-Marie Karat's proposed User's Bill of Rights would be provocative, but I wasn't ready for the hundreds of thoughtful replies that rolled in. I thank you, and I apologize for being able to reply to only a very few of you.

The responses aren't anything close to a scientific sample, but they are enough to convince me that the computer industry has a lot of baffled, frustrated, and unhappy customers. That is a much graver threat to the long-term health of the high-tech sector than the Asian

crisis, the Year 2000 bug, or just about anything else.

Of course, some industry folks took exception to the proposal. The Bill's first article—"The user is always right"—drew much ire from software developers. The pros say that much of the time, users don't know what they want, and when they do, they all want something different. And they won't read manuals or learn about programs.

HOMEWORK. "The fact is, most users rarely are right," wrote Paul Roger of San Diego. "It shouldn't take a PhD to understand that a few hours invested in learning about the computer and its software will make subsequent products intuitively usable." Jef Raskin, who designed the original Macintosh "desktop," doubts that it's possible to make computer use truly intuitive. "For example, the mouse was not intuitive. A person seeing one

for the first time had no idea how to use it. Nonetheless, you could learn to use the mouse in seconds."

A good rejoinder comes from Bill Keller of Portage, Mich., who says he met with disbelief a year ago when he told fellow software developers "the customer is always right." They understood, though, when he said: "This is not a statement of fact. It's a point of view." Karat says: "The user is the customer. Let's delight the customers and not only be responsive to their needs but anticipate them in our designs." (For many more responses to the column, see www.businessweek.com/manifesto.htm.)

A number of readers took me to task for saying computers should be as easy to use as toasters, pointing out that a toaster is only expected to do one simple chore. A car, as many suggested, is a much better analogy. Everyone understands that you can't drive a car without some training, but few drivers have trouble using cars.

Would that the same were true for computers. Tales of woe came from around the world. Fran Darling of Duncan, B.C., complained: "If this industry is making billions of dollars and has had so long to

work out bugs and has so many brilliant people designing programs, how come can't [get my computer to send and receive a fax?]" Kate Kettle of Montclair, N.J., spent hours being shuttled among four companies in an effort to get a Hewlett-Packard Co. printer to work with her Toshiba laptop.

Error messages—particularly the common, cryptic Windows warning that a program has performed an "illegal operation"—are a source of outrage. "My machine sometimes makes me think I'm an idiot!" complains Dunja Vrazic-Stejskal of Zagreb, Croatia.

BILL-BASHING. Microsoft Corp. is clearly the company its customers love to hate. "The No. 1 offender is Microsoft," writes Rick Cunningham of Chandler, Ariz. "The leading in decipherable error messages (that pop up all too frequently), junk software, poor compatibility, and blaming anybody and everybody else." Olaf Edström of Paris says his Internet service provider told him to talk to Microsoft about a known bug, but the company demanded the equivalent of \$50 just to pay a technician on the line.

Apple Computer Inc. gets singled out for praise by its customers. "If Apple had won the PC wars, there is no doubt they would have continued down the path of making the computer an appliance," says Andy Hsiung of Santa Monica, Calif. "Instead, 10 years later, the Windows system we're all using barely approaches the Macintosh in terms of ease of use."

There's one thing missing from this outpouring. I've heard from engineers, programmers, and usability gurus. But the product planners and marketers who make the key hardware and software design decisions have been conspicuously silent. You folks have a lot of angry customers out there. How are you going to respond?

BY JAMES C. COOPER & KATHLEEN MADIGAN

RECESSION? WHAT RECESSION? THE FORECASTERS DON'T SEE IT

Low inflation and rates will support solid, if slower, consumer spending

U.S. ECONOMY Looking for something to break the gloom? Talk to the nation's business economists. Despite global financial turmoil and severe recessions in Japan and emerging Asian economies, the forecasters believe the U.S. economy will grow 3% this year, with the pace slowing to a respectable 2.2% in 1999. Nearly 80% do not expect a recession by 2000. Feel better now?

D.K., it's just a forecast, but as the National Association for Business Economics gathered for its annual conference in Washington, D.C., on Oct. 4-7, a heavy air of impending doom was conspicuously absent. Only six of the 36 forecasters in the NABE's outlook survey expect global woes to cut the 1999 growth rate by more than a percentage point from what it otherwise would be. Low inflation and interest rates will support slower but solid growth in consumer spending, they say, helping to fuel the output and gains necessary to keep this 7½-year expansion going, although at a more moderate pace (table).

HOW BUSINESS ECONOMISTS SEE 1999			
	1997	1998	1999
REAL GDP	3.8%	3.0%	2.2%
CONSUMER SPENDING	1.9	1.7	2.4
LESS DEBT SERVICE	5.0	4.5	4.7

PERCENTAGE CHANGE Q4 TO Q4, EXCEPT JOBLESS RATE, WHICH IS ANNUAL AVERAGE
DATA: NATIONAL ASSOCIATION OF BUSINESS ECONOMISTS

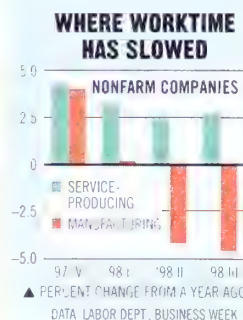
So far, there is little, if any, evidence to dispute the forecasters. September payrolls slowed, but the trend of job growth is probably stronger than last month's small job gain suggests. Despite the September dip in consumer confidence, consumers were upbeat enough to buy new autos at a vigorous pace. And the remarkable rally in Treasury bonds, which took the 30-year yield to 4.71% on Oct. 5, is supporting consumer borrowing and fueling mortgage refinancing. Economic weakness remains confined to manufacturers, who continue to absorb the full blow to the U.S. economy from the Asian crisis—fewer exports (chart).

EARLY, FEDERAL RESERVE economists are a bit more anxious than their private-sector brethren. Recently released minutes of the Fed's Aug. 18 policy meeting show that the central bank's internal forecast expects the economy to grow through 1999 "at a pace somewhat below the estimated growth of the economy's potential," generally accepted to be about 2.2%. That's a significant shift from the staff's previous forecast, which helped to justify the Sept. 29 rate cut.

Fed Chairman Alan Greenspan, who addressed the NABE gathering on Oct. 7, said he is particularly concerned about the ongoing reassessment of risk in the world, sparked by the Russian debt default. The result is less available, and more expensive, credit for many corporate borrowers, and he said the readjustment "hasn't come to an end yet." Still, he said the U.S. was "far short" of a credit crunch, and that the economy still has "fairly significant continuing momentum."

Indeed, as Fed Governor Laurence H. Meyer told the NABE on Oct. 5, the Fed's rate-cut decision was based entirely on a forecast, not on visible evidence of a slowdown. Meyer said that was why the Fed took only a cautious, quarter-point step. He said the Fed generally feels that "phase two" of a global slowdown is headed toward the U.S., but that scenario "depends critically on a slowing in domestic demand." The previously hawkish Fed governor believes that global turmoil will cut growth in U.S. demand by undermining the favorable set of financial conditions that have helped to fuel strong growth.

Weaker stock prices and higher borrowing costs mean that companies will face higher costs. Greenspan noted that the loss of \$1.5 trillion in stock market wealth "has got to show up somewhere." Also, the latest Fed survey of senior loan officers shows that banks are tightening up their lending standards for businesses, especially larger companies that are exposed to potential losses from overseas. As financing costs rise, with profits falling, capital spending could tail off sharply.



CONSUMERS ALSO WILL FEEL the chill of less favorable financial conditions, but maybe not as much as companies. Some households will suffer lost stock wealth, and some will feel the effects of higher business costs as companies slow hiring, especially since labor costs are still growing faster than prices. But keep in mind that the reverse side of rising labor costs and weak pricing power is more consumer buying power.

The first sign of slower payroll gains might have been the September job report, which showed a slim 69,000 increase. The rise was the smallest since January,

1996. Temporary help companies posted losses of 37,000 workers. The trend in temp jobs appears to be turning down after two years of very strong growth. Temps are among the first to go when business slows.

However, other key labor market indicators do not confirm a sudden shift in the trend. A crucial one, the four-week average of new jobless claims through September, was the lowest since 1989, and it shows no sign yet of rising, as it always does at turning points.

To date, the only clear slowdown in job growth is in manufacturing, where overall hours worked have fallen sharply in the second and third quarters. The September report did show softness in service-sector hiring, but it's way too early to call that a new trend.

WHAT IS CLEAR from the NABE forecast is that consumers will have to be the glue holding the economy together in 1999, because the business economists expect little support elsewhere. They say capital-spending growth will be halved, housing will plateau, the trade deficit will widen, and inventory growth will slow. Excluding consumers, they expect growth in the rest of the economy to be barely above zero.

So far, consumers seem up to the task. Despite the financial market mayhem that has shaken their confidence, weekly retail surveys for September show no sudden weakening in buying, and September sales of new cars and light trucks rebounded strongly. The

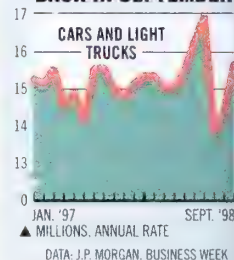
month's 15.6 million annual rate was above the year's excellent 15.3 million average (chart).

Although credit may be harder to come by for businesses, households will benefit from the drop in long-term Treasury yields, primarily through lower mortgage rates. The rate on 10-year Treasuries has dropped a huge 1.2 percentage points from late August to early September, from 5.4% to 4.2%, and 30-year mortgage rates appear headed toward 6.5%.

Lower financing costs will lift spending by supporting demand for homes and related items and through refinancing. Some consumers may cut monthly payments, while many could choose to keep their payment, take a larger mortgage, and pocket the cash.

The key question for the outlook: Are forecasters putting too much faith in consumers? After all, savings are at a record low and debt is high, despite good income growth. More loss in stocks or weaker-than-expected job markets could quickly alter consumers' free-spending ways. One thing is clear from past business cycles: When consumers pull back sharply, they take the rest of the economy with them. Let's hope the forecasters are right.

AUTO SALES BOUNCED BACK IN SEPTEMBER



JAPAN

THE GLOOM JUST KEEPS DEEPENING

Japanese business executives gave new Prime Minister Keizo Obuchi's policy efforts to reverse the economy's slide a big thumbs down, based on the closely watched *tankan* survey of 10,000 businesses. Despite new fiscal stimulus and an interest rate cut, business pessimism in the September quarter rose broadly with no hope for an upturn.

The *tankan*'s key index of business sentiment among large manufacturers slid from -34 in June to a much weaker-than-expected -51 in September, the lowest in four years. The index subtracts the percentage reporting unfavorable conditions from those who say conditions are favorable. The sur-

vey was taken before the lower house of Parliament's Oct. 2 approval of a plan to let the government take over insolvent banks and help them to dispose of bad loans using public funds. The plan may lift spirits somewhat, but the outlook remains bleak.

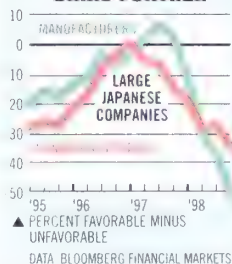
Large nonmanufacturers were also more downbeat. Retailers, builders, realtors, and transporters reported sagging demand, weaker prices and real estate values, and rising bankruptcies. Small companies, especially hurt by evaporating bank credit, were even gloomier. The index for small manufacturers, who expect a 33% plunge in profits this year, fell to -57, the lowest in the

tankan's 31-year history. The index for small nonmanufacturers was the weakest in 15 years.

In addition to slumping Asian markets, domestic demand is also shrinking. Businesses plan 8.7% less capital spending this year, and with August joblessness at a record 4.3%, consumer spending is dead in the water. The latest Tokyo Chamber of Commerce survey shows that 58% of companies plan to cut hiring, with 80% considering cuts.

The government forecasts a 1.6% drop in real gross domestic product in fiscal 1998, the first negative forecast since 1974, but private analysts expect worse. The latest *tankan* has already sparked talk of more fiscal action, but analysts believe the economy now requires stimulus equal to several percentage points of GDP.

BUSINESS SENTIMENT SINKS FURTHER



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PIECE BY PIECE, A PLAN?

There was no "new global financial architecture." And there was plenty of sniping. But the annual International Monetary Fund Conference, held in tandem with a confab of the Group of Seven industrialized nations, may be remembered as a pivotal moment in the effort to tame the emerging-markets crisis.

At center stage was Bill Clinton. Making three speeches between Oct. 2 and Oct. 6 at meetings of bankers, diplomats, and finance ministers, the President thrust the U.S. into the lead of a global rescue mission. "The global economy simply cannot live with the kinds of vast and systemic disruptions that have occurred over the past year," President Clinton told IMF delegates on Oct. 6.

The growing U.S. involvement and the glimmer of a new approach to the problems that have plagued emerging economies for 15 months is the good news. Even as the meetings continued, other pieces began to fall into place. Japan finally seemed to make progress to address some of its structural problems. And suddenly Republicans in Congress appeared ready to negotiate a deal on the \$18 billion in funds that the U.S. has pledged to the IMF.

The bad news is that the President's plans remain vague, coordination be-



STEPPING BACK FROM THE ABYSS

tween the U.S. and other G-7 nations is still fleeting, and the proposed new solutions, which may help head off future calamities, won't do much to help current victims.

What may determine whether this is the beginning of the solution—or another false start—will be what happens with Clinton's plan to save Brazil

DRAWING A LINE IN LATIN AMERICA

A possible \$30 billion aid package for Brazil, plus talks on a regional line of credit, are aimed at stopping the spread of the Asian crisis.

PROTECTING THE GOOD COUNTRIES

The U.S. proposes lines of credit from the IMF to countries with sound economies whose currencies might be sucked into emerging-market downturns.

and Latin America. Treasury Secretary Robert E. Rubin and Federal Reserve Chairman Alan Greenspan are pushing hard to build a \$30 billion firewall funded by the IMF and private banks around Brazil. If it holds, it could start to turn the tide. "Brazil is the Rubicon in the sense of restoring confidence in the emerging markets," says Citibank

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If the IMF can stabilize Brazil, will a turnaround for the rest of the world begin?

On Oct. 7, the Japanese sent optimism—and the yen—soaring with what looks like its most credible recovery plan to date. Tokyo has proposed \$70 billion in new public-works spending and steeper income-tax cuts. And the ruling party is trying to hammer out a deal to use public funds to help relieve banks of \$1 trillion in bad loans. Despite frequent let downs in the past when Japanese reform packages have fizzled, markets cheered. The yen soared against the dollar, to 121.

At the same time, the prospects for more rate cuts in the West brightened. Spain cut its interest rates a half-point on Oct. 6—double the reduction markets had expected—a sign that Europeans may be ready to follow the U.S. in responding to the recessionary threat posed by the emerging-markets plunge. What's more, Bundesbank President Hans Tietmeyer has now indicated that Europe's rates should drop from today's 4% average to Germany's 3.3% by Jan. 1, when the new European Central Bank takes over. Another cut, to 3%, could come early in 1999—particularly if the Fed keeps cutting U.S. rates. "There is clearly the will to counteract a slide into recession," says Rolf E. Breuer, chief executive at Deutsche Bank.

But it's Clinton's intense focus on the crisis—and its growing threat to American prosperity—that's likely to have the most long-term impact. And the raft of schemes now on the table shows that the U.S. is willing to back away from the kind of harsh demands for budget reforms and market discipline that the IMF has insisted upon for ailing economies.

With the U.S. leading, the G-7 industrial nations are now discussing pre-emptive IMF lending to countries that aren't paying their private creditors, "bail-ins" of bankers to force private lenders to share more of the pain of debt workouts, debt-for-equity swaps to ease onerous payment schedules, and modest capital controls to slow the flow of "hot money" into emerging markets.

But the G-7 won't have the luxury to rebuild the financial system until they stop the crisis. That's why Brazil is crucial. Latin America's largest economy lost a third of its hard-currency reserves in September and now has just \$45 billion to defend the real. The \$30 billion rescue would buy time while newly re-elected President Fernando Henrique Cardoso reins in a soaring budget deficit. "Rapid work is being done to implement this aid," says Ar-

BAIL-IN" THE BANKS

wants private to take a haircut on loans to ailing economies before it puts money. First test:

A BIT OF CONTROL

Longer term, the U.S. Treasury, the IMF, and big lenders say controls may be justified to slow funds flowing into—but not out of—developing nations.

COORDINATED RATE CUTS?

European rates may drop by January—from a Continental average of 4% to Germany's 3.3%—while Fed officials hint at more cuts in U.S. rates.

Chairman William R. Rhodes, who is helping to negotiate the package for expected mid-October rollout.

backstop a Brazil rescue, Clinton uses new IMF powers to lend to help economies to protect them from contagion of indiscriminate capital. Clinton's credibility on matters governing the IMF got a huge boost

on Oct. 6, when House Republicans and the White House moved toward resolving their long-running feud over U.S. funding for the cash-strapped IMF. The money, which the Administration expects Congress to approve before it adjourns for midterm elections, would release \$72 billion in funding from other countries.

gentine President Carlos Menem. Argentina, suffering from commodity price drops, could be the next victim if Brazil falls.

Atop the Brazil rescue, the IMF and other global financial institutions hope to erect a regional defense fund, says Menem. It would be stocked in part with contributions from the world's biggest banks, to protect the rest of Latin America from contagion.

Greenspan is contributing to the defense of the Latin economies as well. The Fed chief and his European counterparts are leaning on bankers to keep their cash in developing countries with sound economies, such as Argentina, Chile, and Mexico.

which the new approach by bankers and policymakers will be immediately tested. Finance officials are nervously eyeing a new confrontation in Ukraine, which has angered investors by refusing to make dollar-denominated bond payments that would take the country's reserves below the IMF-imposed minimum. To avoid a Russia-style default and further market hysteria, the IMF is pressuring the lenders to take a haircut—and two-thirds have agreed to reschedule their loans. This showdown could test the IMF's new resolve to make lenders responsible for decisions they made during the years of emerging-market euphoria. If the tough stance works, it could be codified in the IMF's rules.



"Brazil is the Rubicon in the sense of restoring confidence to the emerging markets," says Citibank's Rhodes, one of the rescue negotiators

A CARDOSO POSTER: POST-ELECTION, HE'S VAGUE ON SPENDING CUTS

Will the line hold? Brazil is a good place to take a stand because Cardoso is the living symbol of the fight against hyperinflation, and he has just received a new mandate to press for economic reforms. But his government's deficits are rising, and many economists say the real is overvalued by as much as 15%, making it a target for speculators. And Cardoso's new term isn't getting off to a great start: In an Oct. 7 speech, the first since his reelection, he punted on new proposals to trim spending, promising only to propose new fiscal measures in the near future. That sent the Brazilian market tumbling.

Latin America isn't the only front on

By themselves, such small changes aren't the bold architectural redesigns that victims of the current crisis are crying for. But by drawing a line in Latin America, getting tough with lenders, and spotlighting the urgency for bold action, Bill Clinton and the G-7 have taken a big step toward bucking up the system. "Restoring confidence is the name of the game," says Citibank's Rhodes. That may be the monetary mavens' greatest accomplishment.

By Mike McNamee and Kerry Capell in Washington, with Ian Katz in São Paulo, Carol Matlack in Moscow, and Thane Peterson in Frankfurt

COMMENTARY

By Pete Engardio

CRISIS OF FAITH FOR THE FREE MARKET

It has taken more than a year, but major industrialized nations finally seem to be starting to come to grips with the crisis in emerging economies. The billions that the Clinton Administration is now trying to mobilize to avert the contagion from bringing Brazil and other Latin countries to an important step. So, too, is the pressure by industrialized countries to promote growth and expand liquidity.

But calming the immediate crisis and restoring investor confidence is only a first step. The bigger challenge facing Western policymakers is to restore worldwide confidence in globalization itself. The biggest casualty of the emerging-markets meltdown could be the developing nations' belief in the benefits and inevitability of globalization. That faith has been damaged by a year of ineffectual and hypocritical hectoring by the West. **DONE IN BY DOGMA.** While it may not have been evident at the Oct. 5-8 World Bank meeting itself, where leaders of countries ranging from Brazil to South Korea took pains to stress they are not backing down from free-market reform, there have been mounting signs of retreat in recent months. Russian President Boris Yeltsin was forced to stall old Communist Party stalwarts in key economic posts. Malaysian Prime Minister Mahathir Mohamad has imposed stringent currency controls. In Sept. 28 speech in New York, Indian Prime Minister Bihari Vajpayee instructed the type of Third World rhetoric not heard in two decades, declaring the "world is paying the price for the dogma of the invisible hand of market forces" and calling for "radically changing the global economic order."

It's easy, of course, to dismiss Mahathir and Vajpayee as relics of a gone age. Few would argue that the remarkable rise in living standards in East Asia and some of Latin America could have been accomplished without the surge in foreign trade and investment. But what is at issue now is

poor nations really expose themselves narrowing effects of they to achieve their ic goals. Sure, the i of foreign funds in y 1990s produced ing growth in many but the sudden wal is resulting in catastrophe and ruin, viable export busi- in Indonesia, South and Thailand. rise, dozens of na- currencies and stock have been tram- the wake of Russia's -as investors indis- ely bail out of g economies and virtually shut off new credit or price beyond the reach vers. After lending ion to emerging between 1993 and eign banks are on the brakes ere. "The worrying 'this crisis is the iffentiation," says Finance Minister Aninat Ureta. "We g countries being s commodities, like ilver." esult, the private ws that were sup- reward well-man- omies are instead all developing . As money rolls the U.S. and Europe, the orces that promised to spread l across the globe are now, y, restoring the old North- ve-have not divide. Third World delivered one in Washington, it was this: ill willing to buy into global- o long as we can be sure it living standards if we follow And from now on, we want olved in making those rules. ng countries can't just be lobal template for a financial re and told to take it or said Indonesian economist gestu. "They have to be part ecess." why the near collapse of Long- ital Management may be a disguise. Now that the U.S.



INDIA'S VAJPAYEE: Biting "the invisible hand of market forces"

The "rewards" of reform are proving too punitive for the emerging economies. If they can't have a say in the rules, they'll revolt against them

ceded that "this is a time for hard thinking, recognizing errors, and bold action."

One sign of the new line: Last year's orthodoxy that emerging nations should make their currencies freely convertible as soon as possible and dismantle any curbs on capital flows is being repealed. The Institute of International Finance, the Washington think tank for the world banking community,

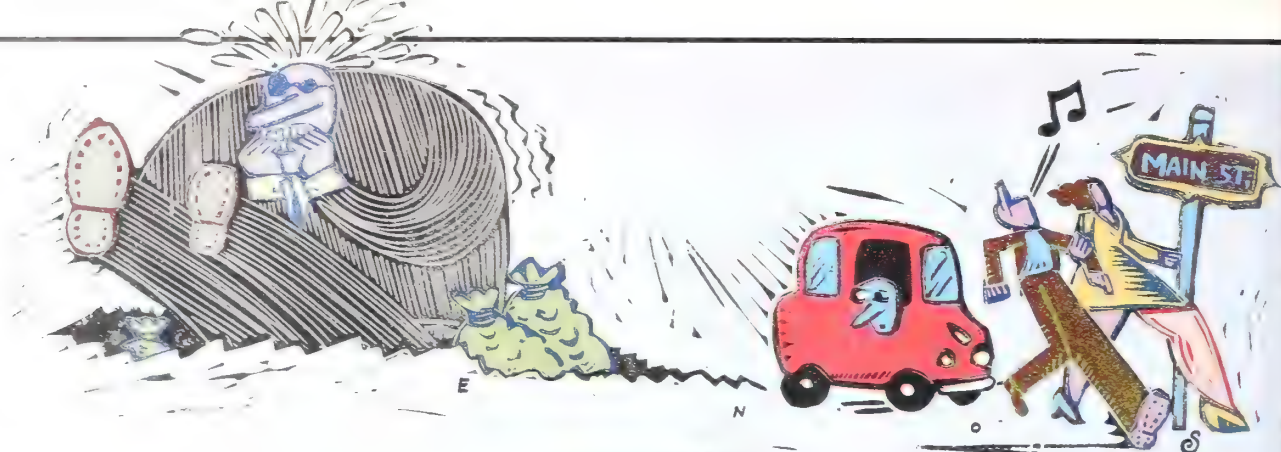
and European financial elite have been burned by the effects of hot-money flight, Western leaders who were deaf to the plight of the developing nations are paying attention. Indeed, the change in tone from last year's World Bank confab was dramatic. At that time, the main proponents of reining in global hot money—Mahathir and financier George Soros—were dismissed as gadflies.

This year, similar anxieties were sounded by such deans of high finance as William J. McDonough, the New York Federal Reserve President who arranged the Long-Term Capital bailout. The credit crunch and speculative attacks on Latin countries, he said, "shows that what we believed is a very rational world financial system can be very irrational." A chastened IMF Chairman Michel Camdessus con-

now advises developing nations to remove capital controls only after their financial institutions are sophisticated enough to manage the turbulence. That view was echoed by the likes of Bankers Trust Chairman Frank N. Newman, Bank of America Chairman David Coulter, and HSBC Holdings Chairman John R. H. Bond.

What developing nations should do while a more coherent, and less dangerous, international financial order materializes is unclear. But G-7 leaders had better start making progress fast. Otherwise, country after country will start charting their own courses to protect their economies.

Engardio is a senior editor for the International edition covering Asian affairs.



COMMENTARY

By Howard Gleckman

LET'S NOT TALK OURSELVES INTO A DOWNTURN

Forget Viagra. Somebody get the Prozac. The financial markets and the pundits who track them have fallen into a funk. Japan is stuck in its decade-long rut. Russia is a wreck. And Latin America is on the brink. At home, the Standard & Poor's 500-stock index is off almost 18% from its highs this year. And lenders and investors have swung from a belief that no investment is too risky to a gnawing fear that none is too safe. As a result, investors have been fleeing to the mattress-like safety of Treasury bonds as if anticipating a 1930s-style depression.

Yet, the nation's economic fundamentals remain solid. Sure, unemployment was up a tick last month. But it remains at 4.6%—a stunningly low level not seen since the 1960s. And while consumer confidence has fallen from its peak in June, it's still twice as high as it was five years ago, according to the Conference Board. Consumers continue to spend—auto sales were up 6% last month. And the overall economy is likely to grow at well over 2% for the rest of the year. That's no boom, but it is hardly a recession.

But if we work hard at talking ourselves into it, there's still a chance of falling into a deep and prolonged slump. It's a task the financial and media elite have taken up with gusto. Says Federal Reserve Chairman Alan Greenspan—who's usually a voice of reason: "If you read the newspapers in the morning, you get

the impression that the economy has collapsed, and we all might as well go home and go fishing."

Greenspan, like other observers, is left scratching his head. Investors are acting as if they're stuck with devalued Malaysian ringgits, not shares in U.S. corporations. And as frenzied American money managers dump stocks and corporate bonds in favor of government paper, look at how much spreads have widened between Treasury

COOL IT If pundits and investors keep panicking, they might turn a mere slowdown into a recession

rates and corporate bonds. While 10-year Treasury yields have plummeted to 4.2%, the lowest levels in three decades, top-rated long-term corporate bond rates are stuck at about 5.9%. Says First Union economist Veronica White: "Nobody wants to hold corporates."

There are signs that banks are tightening their purse strings as well. A recent Fed survey of loan officers suggests they are raising credit standards and demanding more collateral for loans. That's not all bad, as long as lenders don't get carried away. If they all batten down the hatches, William J. McDonough, president of the Federal Reserve Bank of New York, told reporters on Oct. 5, "there is a significant possibility of a credit crunch."

It's even worse with equity financing. Initial public offerings are disappearing, and financing for real estate investment trusts is nearly impossible to find. "Pretty much across the

board, the cost of equity capital has gone up," says Fleet Financial Group Chief Economist Nicholas S. Perna.

Consider retailer Kmart Corp. First-half net income was \$80 million, up 158% over 1997. Sales are up a solid 5% so far this year. Kmart's stock price? Off 45% in four months.

So far, this squeeze hasn't had a huge impact on the real economy. Capital investment is slowing, but still growing at more than 7%. Many companies continue to buy new equipment, in part to sub for chronic shortages of skilled workers.

But some parts of the economy show signs of slowing, thanks to a shortage of money. One victim: commercial real estate. "It's the first time the capital markets have stopped development," says Dennis Yeskey of Deloitte & Touche.

LIQUIDITY TRAP. The perverse bottom line: While consumers are flush, and lenders and investors are sitting on plenty of dough, the U.S. could be heading for a liquidity trap. If access to capital becomes more difficult, investment may dry up and unemployment could rise. Then, there would be nothing for those mall-happy consumers to do, except to put away their wallets and credit cards.

Before that happens, everyone needs to stop and think for a minute. The worldwide economic malaise is slowing domestic growth—and the threat becomes more dire if Latin America is allowed to fall victim. But the U.S. economy has been so robust that a slowdown hardly means recession. Bankers and investors just need to keep their wits about them.

Gleckman covers economics from Washington.

REGIONS

HIS ISN'T YOUR FATHER'S RUST BELT

The Midwest is more resilient today as it braces for a slump

They were monuments to the devastated economy of the Rust Belt. In the early '90s, the hulking machines Caterpillar, Deere, and Case stood lined on dealer lots, on farms, and on construction sites across America. The early downturn in the industry helped make the Midwest the biggest regional victim of that recession. But thanks to changes in production and marketing

turnings and a more diversified customer base, many executives feel Midwest industry will be more resilient in its first major test since the 1991 recession. And if the Midwestern manufacturing sector remains a bellwether for the health of the overall U.S. economy, that's good news for the rest of the nation as well.

Even now, the Midwest—which has been feeling the heat from the Asian

What's more, unlike in earlier downturns, low interest rates are giving a lift to consumers. That is fueling a boom in everything from auto sales to home construction. In fact, the Big Three are boosting production to keep up with demand and expect industry sales this year to again top a robust 15 million vehicles. And makers of big-ticket items from Harley-Davidson bikes to Cobalt boats see continued strong demand. At the same time, while labor shortages constrained the upturn in the Midwest, it may now soften any downturn. Unemployment in August was just 3.5%, a full percentage point behind the nation's.

And in general, management at companies that are feeling the pinch now are showing faster reflexes. Inventories of U.S. farm equipment are at six



STEEL PLANT: Industry is moving nimbly to adjust to the downturn

regions, these same manufacturers became the very engines of growth for a robust economy that was a key driver in the nation's export-led expansion.

ADJUSTING. Nearly a decade later, some of these growth engines are sputtering. Buffeted by weak export markets and a bleak farm economy at home, Deere & Co. and Case Corp. are cutting production and laying off workers, brace for a 20% fall-off in agriculture equipment sales in North America next year. At the same time, steel mills in Ohio and Illinois are thinning head count and closing blast furnaces in the face of a 40% drop in imports from Asia, eastern Europe, and Russia. And now the aggressive push by Midwest companies into new markets is haunting them.

Still, the Midwest is in far better shape to withstand a downturn today than it was eight years ago. Thanks to restructuring

and a more diversified customer base, many executives feel Midwest industry will be more resilient in its first major test since the 1991 recession. And if the Midwestern manufacturing sector remains a bellwether for the health of the overall U.S. economy, that's good news for the rest of the nation as well.

A huge difference is the cash cushion in Midwestern institutions. This time, banks, which entered the 1990 downturn stuffed with bad real estate loans, are not nearly as exposed to problems in Asia and elsewhere. And although the farm debacle is brutal across some of the Great Plains states, others such as Iowa have courted manufacturing and insurance companies, so that farm income is just 7% of total output, down from nearly 12% in the early '90s.

months, half the levels of the '91 recession. Says Case CEO Jean-Pierre Rosso: "We are addressing the downturn in the ag market much earlier than anyone has done in the past." Meanwhile, these same companies are keeping up investments aimed at a post-slump world economy. Case, for example, is plowing ahead with a new tractor line, while Caterpillar Inc., despite turmoil in Russia and the economic problems in Brazil, is pushing ahead with new projects in both countries.

Will it be smooth sailing through the uncertain economic waters? Far from it. The worst fears are a protracted farm slump, wider global turmoil, especially in key export markets like Canada and Mexico—concerns that are by no means confined to the Midwest. But, come a downturn, it's far less likely the engine in the Heartland will grind to a halt.

By Richard A. Melcher, with De'Ann Weimer, in Chicago and Peter Galuszka in Cleveland

COMMENTARY

By Michael J. Mandel

THE NEW ECONOMY: FOR BETTER OR WORSE

Signs of impending slowdown are all around. With turmoil worldwide and U.S. corporate profit growth slowing, the stock market has dropped by about 17% since its July peak. The economy generated only 69,000 jobs in September, even while the collapse of Long-Term Capital Management suggests that the U.S. financial sector may be shakier than many had assumed.

Is this the end of the so-called New Economy? Hardly. The New Economy has never been about sunny skies forever. Rather, it has always been a good-news/bad-news story. The same forces that create the conditions for faster growth in the long run also lead to volatility and turbulence in the short run—and right now we are seeing the dark side.

Let's summarize the good news first. The conventional wisdom has been that the U.S. was a mature, slow-growth economy, doomed to 2%-to-2.5% annual growth for the indefinite future. Instead, a striking wave of technological innovation—centered in information technology but not limited to it—combined with globalization has reenergized the U.S. economy.

BEST AND WORST. Over the past three years, growth in gross domestic product has averaged 3.7%. Rising productivity has boosted both real wages and profits. And core inflation has fallen from 3% to 2.4%, despite an unemployment rate well below 5%. If the current pace of technological innovation continues, it seems likely that the U.S. economy can sustain a long-run average growth rate of 3% or more.

But the bad news is that while the economy remains on a path to long-term prosperity, there will also be wide swings—long booms punctuated by deep busts. Indeed, globalization and technological change can help create the conditions for finan-

cial crises and sharp recessions.

A New Economy recession would be different from the recessions the U.S. has seen over the past 25 years. In those that occurred in 1974-75, 1981-82, and 1990-91, productivity plummeted as businesses could not cut costs and boost effi-

periods of rapid productivity growth. From 1900 to 1950, the widespread introduction of such new technologies into the economy as electricity, the automobile, and radio sent productivity soaring, and doubled the real income of Americans. But that same 50-year period also included the worst

SLIPPERY

While the economy is on the path to long-term prosperity, there will also be wide swings—long booms, deep busts

downturn: the devastating Great Depression of the 1930s.

Today, it's clear that both globalization and technological change are creating new risks. The increased interconnectedness of the global economy means that economic or financial disturbance in Asia or Russia can be transmitted much faster and more powerfully to the rest of the world. Witness the signs of a liquidity crunch in the U.S., thanks in part to the flight to quality that began in Asia.

Beyond that, the current

dependence of the U.S. economy on high-tech spending raises disturbing questions. Today, about 30% of U.S. economic growth comes from high tech, primarily business capital spending and consumer purchases of home computers. As a result, a mild slowdown in the economy could quickly expand into a major downturn if prudent execs delay technology purchases and worried consumers cut back on discretionary spending, such as purchasing a second computer.

In the short run, there's little doubt that the U.S. economy will be dragged down by the global crisis. But it's what happens to productivity and growth in the long run that really matters—and that will be the true legacy of the New Economy.

Mandel covers economics



But these job cuts, even if they lead to increased efficiency, could exert a strong downward pull on the economy in the short run. Indeed, the historical record from the first half of the 20th century suggests that scary downturns are often associated with

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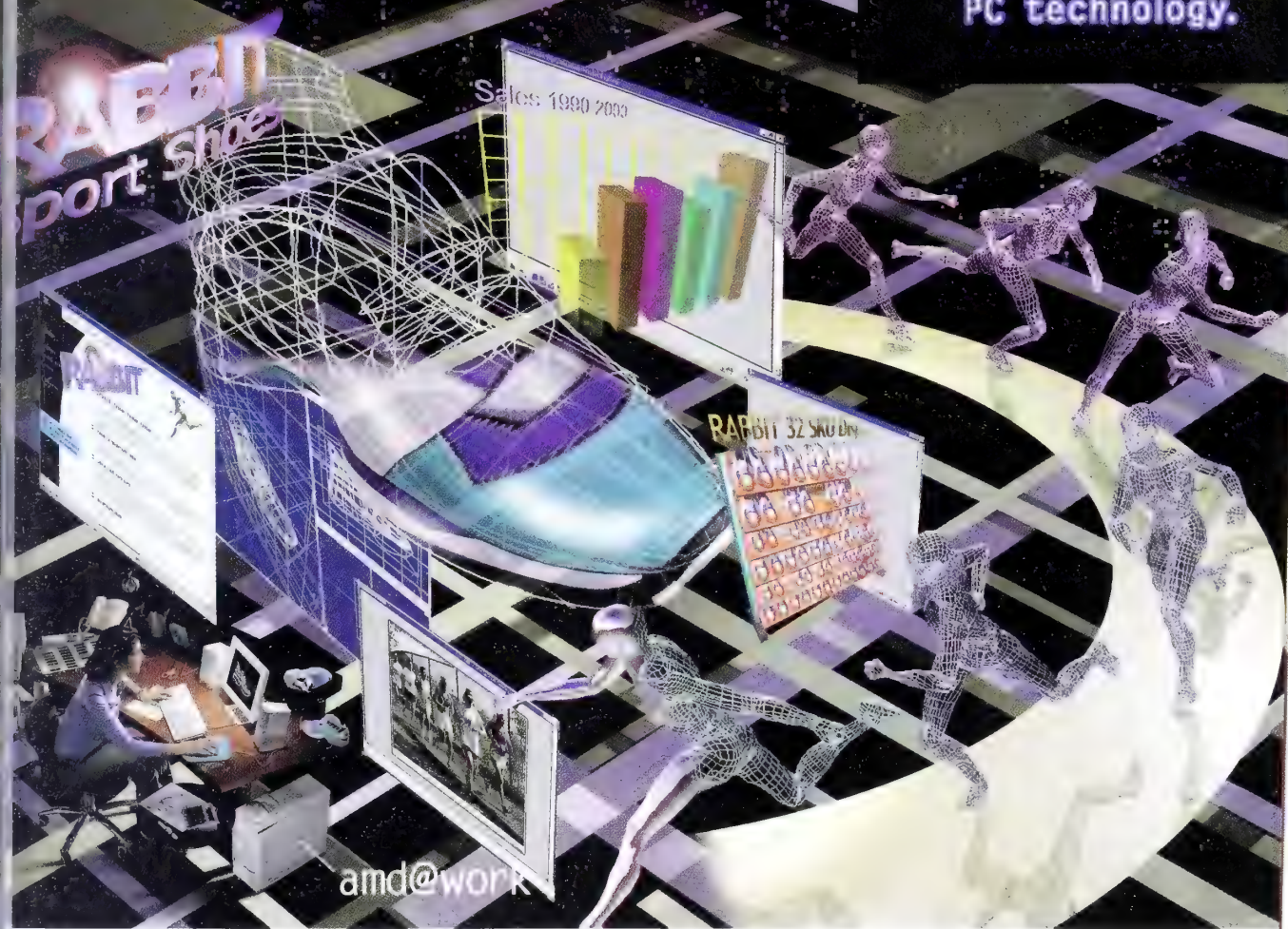


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RETAILING

WE NEED A LITTLE CHRISTMAS NOW

Too early to haul out the holly? Not for worried retailers

If only they had had Christmas in July this year. Retailers were placing critical orders for the holiday season—before the emerging-markets crisis had spread, the U.S. stock market had given back its 1998 gains, and consumer confidence had started to erode. The U.S. economy still seemed insulated from the global mess and in no danger of sinking into recession. Retailers placed big orders, assuming that the consumer-spending binge would last.

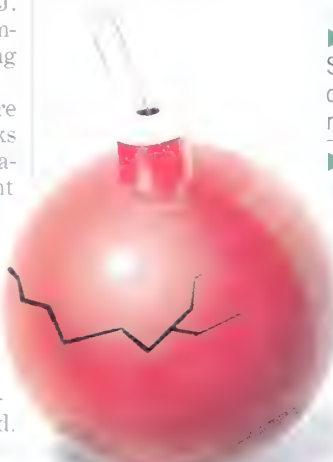
Now the question is, when December arrives, will retailers be stuck with warehouses of unsold goods? "We don't think you're going to see a lot of people just throwing money around over the next few months," says Marvin J. Girouard, chief executive of Pier 1 Imports Inc. "The buying binge is slowing down a bit."

To minimize the damage, retailers are maximizing the selling season. Weeks before Halloween, Christmas decorations are popping up in department stores. So are deep discounts, as merchants try to jump-start the holiday shopping spirit. "There's a lot of hand-wringing going on among retail executives," says Kurt Barnard of Barnard's Consulting Group.

How bad could it be? Consumer confidence, measured by business research group The Conference Board,

has slipped for three months running, and stores have reported slower sales gains since the summer. September sales, scheduled for release on Oct. 8, are likely to be disappointing for many retailers. A consumer mood survey by Leo J. Shapiro & Associates shows about 27% plan to spend more this holiday season, down from 32% last year.

In addition to rushing the season, some retailers are taking defensive action. J.C. Penney Co. says it will delay taking delivery of clothing shipments to guard against overstocks. Sears Roebuck & Co.



CLAUS ENCOUNTERS: Stores already want shoppers to be Yule-conscious

also plans to wait several weeks before deciding how much clothing to stock this season. Despite disappointing sales in August and September, Federated Department Stores Inc. says the company has no plans to alter its clothing purchases, according to a spokeswoman. But she adds that Federated, parent company of Macy's and Bloomingdale's is "monitoring the situation closely."

Meanwhile, stores and malls are rushing out holiday decorations. Cherry Creek Shopping Center in Denver has already opened its seasonal Christmas. On The Mall store, more than a month earlier than last year. Bed, Bath & Beyond Inc. has stocked holiday cards and gift wrap alongside its Halloween displays. "It gets people in the mood," says a store manager.

JUST A BUMP? Many stores are bringing out their biggest guns: price cuts. Athletic footwear, usually hot in August and September, is as much as 50% off at Foot Locker. Macy's has already marked winter coats down, while a sale at Bednetton's includes price cuts on hats, scarves, and wool slacks.

The tactics may be working with some consumers. Annette Mayer of Paris, Tenn., says the price cuts are "good news for the shopper." She has changed her plans to shop for children's clothes, some new baby furniture, and computer games this year. "The stock market has gone down, but it's just a bump in the road," she says.

While apparel sellers are concerned, other retailers can benefit from a thrifty season. Discount king Wal-Mart Stores

Inc. saw sales at stores open at least one year rise 9% in September. Sellers of durable goods figure a more practical consumer will turn from clothing to their stores. "We just mailed our new catalog for the holidays and the phones are ringing already," says Bettie Kahn, spokeswoman for Crate & Barrel. "That tells us business is going to be brisk." For some, at least.

By Ellen Neuborne, in New York, with DeAnn Weimer in Chicago and Stephanie Anderson Forest in Dallas

NOT MUCH GREEN THIS SEASON?

Signs of December troubles for retailers:

- ▶ Discounts have begun. Some fall and winter merchandise has been cut as much as 50%.
- ▶ New clothes are on hold. Apparel makers say merchants are holding back on orders.
- ▶ Holiday decor is up. Weeks before Halloween, Christmas shops and merchandise are creeping into stores.



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SOFTWARE

WINDOWS: WHAT'S THE REAL COST?

Two groups blast Microsoft's image as benign monopolist

As the Justice Dept. and 20 states have gone after Microsoft Corp., consumers have remained on the sidelines. After all, the practices the prosecutors object to—such as bundling its Web browser with Windows—may hurt rivals, but not customers. Every year, PCs get cheaper and Windows gets more features. So what's not to like?

Plenty, according to a report released

to PC makers. Those deals, they say, force consumers to buy more than they need and mask true costs.

What's more, those costs have been going up. Drawing on a wide range of sources, the report shows that Microsoft prices have remained stable or risen as prices have tumbled elsewhere in the PC industry. The price Microsoft charges PC makers for operating systems, for instance, has doubled, from \$21 to \$24 in 1991 for Windows and MS-DOS—about 1% of a PC's total cost—to between \$45 and \$60 for Win98, or about 4% of a low-end PC.

The report also slams Microsoft's retail pricing. For example, the store price for Win98 is roughly twice that of Windows in '91—though to be fair, Win98 has many more features than DOS.

Microsoft spokesman Mark Murray disputes the groups' analysis and says their

conclusions are incorrect. The report, he says, is the work of "anti-Microsoft" forces trying to whip up feeling against the company on the eve of the antitrust hearing. He adds that the brisk retail sales of Win98—2.5 million copies in three months—show that consumers approve of what the company is selling.

To be sure, it's tricky to compare prices for old programs with newer ones with more features. But research by PC Data Inc., which tracks such sales, seems to support the consumer advocates' findings: The average retail

price of all Microsoft software went from \$91.27 in 1996 to \$106.17 now. In contrast, the average price for all software tracked by the firm was \$44.08 in 1996, dropping to \$41.70 in 1998.

Echoing the Justice Dept.'s claims, the consumer groups warn that, unchecked, Microsoft's dominance in software could extend to the Net and raise costs there, too. And they're asking Senator Orrin Hatch (R-Utah), head of the Senate Judiciary Committee, to consider oversight and possible legislation to rein in the software maker. So even if Microsoft beats Justice in court, it may still have trouble in Washington.

By Amy Cortese in New York



The report says Microsoft cost the public "hundreds of millions of dollars in excess charges"

on Oct. 7 by two consumer groups, the Consumer Federation of America and the Media Access Project, a nonprofit public-interest law firm. The 115-page "The Consumer Case Against Microsoft" contends that Microsoft has cost consumers "hundreds of millions of dollars in excess charges" while denying them choice and stifling innovation. The report says that Microsoft's operating-system prices—both to PC makers and through retail—are more than double what they would be in a competitive market, assuming annual price declines of 3%.

In particular, the report attacks how Microsoft markets the combination of operating system and applications software

BUSINESS' FIRST CHOICE



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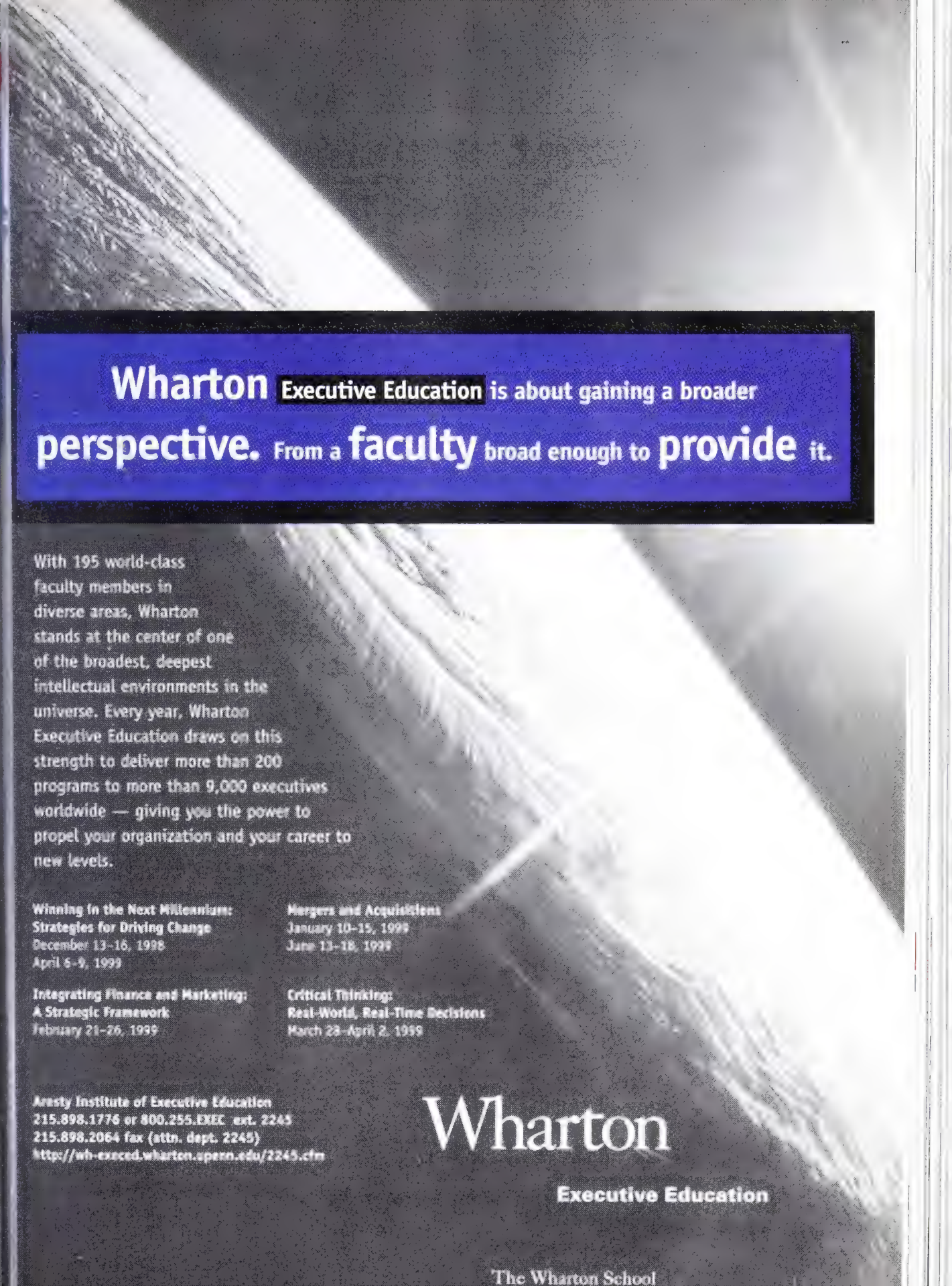
CHIPPING AT INTEL'S LEAD

AMD is getting a lock on the sub-\$1,000 PC market

All right, so "AMD Inside" doesn't quite roll off the tongue like the popular Intel Inc. ad campaign. But it's a fact: Suddenly, AMD chips, not those of Intel, are inside the majority of personal computers now sold through U.S. computer stores. During the first three weeks of September, nearly half of all the desktop computers sold through retailers used the AMD K6 microprocessor, according to market researcher Data Inc. That's a dramatic gain from a year ago when 92% of those same machines had Intel chips inside. Now, 43% of retail PCs sold use Intel. Says International Data Corp. analyst Ken Henry: "PC makers finally have a viable alternative."

BIGGER CHALLENGE. And AMD itself is looking a lot healthier. On Oct. 6, chip maker AMD wowed Wall Street by reporting a \$1 million profit for its third quarter ended Sept. 27. Analysts were expecting the company to lose around \$15 million for the quarter. AMD lost \$31.7 million during the third quarter last year. Thanks to its K6 chip, revenue for the quarter grew 15% to \$685.5 million, up from \$596.6 million a year earlier. Crows AMD CEO W.J. Sanders: "The K6 carried the water."

The K6 is kicking silicon where Intel is weakest: microprocessors for sub-\$1,000 PCs, which are expected to make



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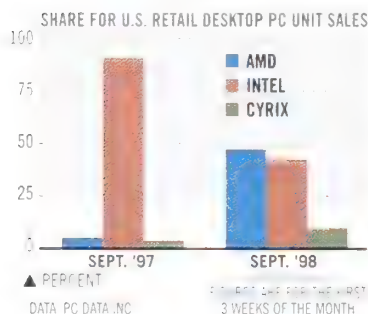
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up between 50% to 60% of computer sales this holiday season. With a 24% share of that segment, Intel is trailing far behind AMD, whose chips are in 58% of the sub-\$1,000 PCs sold. Analysts believe AMD's share of inexpensive PCs could reach as much as 65% during the fourth quarter.

CHEAP THREAT. Intel may have a bigger problem ahead. The real danger, analysts say, is the erosion of Intel's stellar status in the highly profitable corporate and PC-server markets. What AMD's market-share gains suggest is that consumers are buying PCs based on price, not the brand of microprocessor. Corporate buyers, analysts say, may follow suit. The momentum of K6 in consumer markets "gives AMD sufficient credibility to attack the corporate market," says Vadim Zlotnikov, an analyst at Sanford C. Bernstein & Co.

A GIANT'S SHRINKING SHARE



To be sure, Intel is not in grave danger. IDC's Henry figures 82% of all desktop PCs sold in the U.S. this year will use Intel microprocessors. AMD, meanwhile, is likely to finish the year with a 12% share of all machines sold. And Zlotnikov sees Intel retaining 92% share of PC revenues, compared to AMD's 6%.

Still, analysts aren't sure those percentages will hold. Intel isn't talking about its plans to stop the losses to AMD as well as to Cyrix Corp., another rival chipmaker. Experts say Intel has to continue cutting the price of its low-end Celeron microprocessors, which are still at least 10% more expensive than AMD's K6. But analysts are more focused on Intel's ability to protect its high-end chip business, which produces its fattest profits. They expect the company to step up the introduction of higher performance chips, including more powerful versions of its Pentium chips. "They can't afford to lose that edge," says IDC's Henry. Not with AMD having the inside track with consumers.

Ira Sager in New York, with Andy Reinhardt in San Mateo, Calif.

THE INTERNET

ANY PORTAL IN A STORM

Netscape aims to be top pick for business entry to the Web

For months, Netscape Communications Corp. has been looking like an Internet has-been. As portal sites such as Yahoo!, Excite, and Lycos scooped up enthusiastic Netizens, Netscape—the original Internet company—idled. Battered from its Web browser war with Microsoft Corp. and late to the portal game, Netscape seemed stuck in the slow lane.

Now, Netscape has a new plan to get back in the game. On Oct. 8, the company was scheduled to announce a strategy to make its NetCenter site the portal of choice for businesses. The idea is to make NetCenter the heart of corporate "intranets" by using it to blend corporate information—sales updates, stock quotes, travel, or expense policies—with a customized selection of fare from the World Wide Web.

It's another move in Netscape's six-month-old strategy to concentrate on corporate Internet technology. Yahoo! and Excite have developed consumer audiences that are generating hefty advertising revenues, but they don't yet have the contacts and technology to address the business market. The only viable competitor is PointCast Inc., which sells a similar service to companies like Hewlett-Packard Co. Says Netscape Executive Vice-President Mike Homer: "This is an area where we have more experience than anyone."

TRAFFIC PROBLEMS. Netscape isn't conceding the race for consumers. NetCenter is still the fifth most visited site on the Web and generates \$39 million in ad revenue as a result—about 26% of Netscape's \$150 million in revenues, in the quarter ended July 31. But many of those visitors are automatically directed to the Netscape site when they use Netscape's Navigator browser. With Netscape's browser share falling to 41.5%, from 50% in the first half of 1998, according to International Data Corp., the company needs to drum up more traffic.

Corporate portals could help. Netscape succeeds in signing companies up for the service, it stands to add new visitors to NetCenter by the wagonload, roping in every employee with a PC. Visteon Automotive Systems, for instance, a \$17 billion auto-component division of Ford based in Dearborn, Mich., is making plans to hook up 12,000 employees in 21 different countries to NetCenter.

RENT THIS SPACE. How will Netscape make money off its corporate portal business? The same way it does now—by selling ads and network links to businesses that want to reach NetCenter visitors. Those ads would appear only when corporate users venture outside the business intranet—still using the NetCenter filter—to get their fix on the Web. Next spring, according to Homer, Netscape will begin adding links to con-



CLICK FOR CASH
Netscape's Homer: Give corporations a custom-made Web center, and make money off ads and links

pany-approved vendors such as office supply companies or software stores with those vendors paying Netscape for that real estate.

For all the promise of corporate portals, analysts aren't changing the earnings estimates yet. Homer wants business services to add 20% to 30% to NetCenter's revenue stream, projected to reach \$44 million in the quarter that ends Oct. 31. "It's an important strategic sales tool," says Daniel Rimer, an analyst with Hambrecht & Quist LLC. It could also be coming to desktop near you.

By Paul C. Judge in Boston, with Steve Hamm in San Mateo



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EDITED BY PAT WECHSLER

JUSTICE TRIES TO BUST A CARD GAME

ON OCT. 7, THE JUSTICE DEPT. filed a long-simmering antitrust suit against Visa and MasterCard International. The allegations include claims that the card networks stifle industry competition. The suit seeks to end Visa and MasterCard rules that bar member banks from issuing cards offered by smaller rivals, such as American Express and Discover/Novus. Justice also contends that Visa and MasterCard don't effectively compete with each other because the same banks own both networks. The government wants banks to have a governing role in only one card company. Some credit-card experts contend that if

big banks must drop one card from their rosters, that could lead to customer disruptions and big costs.

AMAZON.COM FEELS THE HEAT

GERMAN MEDIA GIANT Bertelsmann and Barnes & Noble are joining forces in a bid to unseat leading cyber bookseller Amazon.com. On Oct. 6, Bertelsmann agreed to pay \$200 million for a 50% stake in barnesandnoble.com. The bookstore giant retains the other half. Each agrees to contribute \$100 million in fresh capital. An IPO for barnesandnoble.com is on hold until 1999's first quarter, and Bertelsmann still plans to launch its own Books-Online in Europe in November. The deal unsettled Amazon investors: Shares dropped 14% the next day.

HEADLINER: RICK WAGONER

STATIONING WAGONER

Rick Wagoner and General Motors are enjoying October so far. On Oct. 5, GM announced it

recouped more than nine points of market share in September to reach 30.5% of U.S. car and truck sales, recovering neatly from summer's strike. Next day, GM announced a global consolidation that anointed Wagoner, the 45-year-old head of GM's North American auto business since 1994, as COO and president of the newly unified \$136 billion domestic and international auto business. That puts him second in line to succeed CEO Jack Smith.



Still ahead: Vice-Chairman Harry Pearce, 56, who is being treated for leukemia.

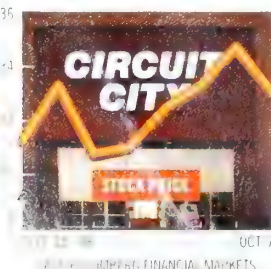
With this shuffling of seats, the odd man out is Louis Hughes, considered Wagoner's main rival. Hughes fell out of favor after prolonged squabbling with GM managers in Europe. As president of GM's domestic auto business, Wagoner boosted net margins from 0.7% in 1994 to 2.7% for the first half of 1998, although GM's U.S. market share fell more than four points in that same period.

By Katie Kerwin
in Detroit

CLOSING BELL

SHORT CIRCUIT

Circuit City shares got a lift on Oct. 6 when the retailer announced strong September sales, up 21% overall and 11% on a same-store basis in its consumer-electronics business. But shares fell the next day to 31 $\frac{1}{2}$, 43% off their 52-week high, set in July. Investors continue to be concerned about Circuit City's new ventures: its Car Max superstores, where same-store sales were off 3%, and its launch in September of a DVD player, called Divx, with disks that are incompatible with players on the market.



STATE FARM GETS HAULED INTO COURT

CUTTING CORNERS CAN COST you. Just ask State Farm Mutual. The U.S. Supreme Court recently decided that the nation's largest property and casualty insurer will have to defend itself against a \$2 billion class action in Illinois next spring. The suit, which State Farm had asked the court to limit in scope, alleges that it violated policy contracts by forcing customers to accept cheaper parts to repair wrecks, instead of replacing parts with ones identical to the carmaker's. As many as 5 million State Farm policyholders in up to 48 states could join the suit.

A SHINY QUARTER FOR MOTOROLA

FEELING A LITTLE MORE CHIPPER? Motorola is giving investors a glimmer of hope

that it can recover from its woeful financial performance of late. On Oct. 5, the maker of chips and telecommunications gear released third-quarter earnings that soundly beat Wall Street's expectations. Motorola earned \$40 million, or 7¢ a share, before special charges, on sales of \$7.15 billion. The numbers surprised analysts who predicted earnings of a penny. More important, Motorola—which has said it needs to save \$750 million and cut 15,000 workers—bested its own estimate of cost savings of \$100 million in the quarter by 40%.

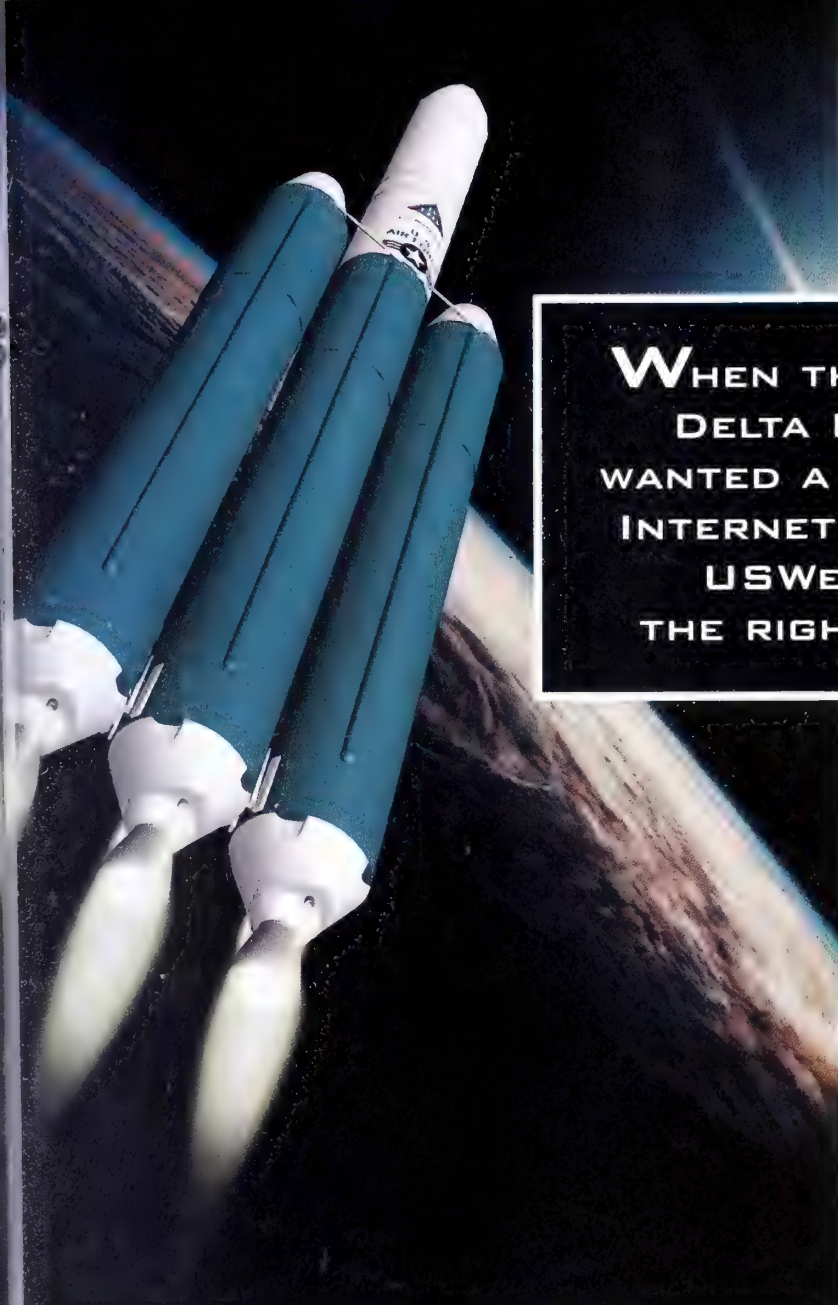
BOSTON CHICKEN'S SKY IS FALLING

BOSTON CHICKEN IS OFFICIALLY fried. On Oct. 5, five years after it was one of the hottest IPOs of the year, it filed for Chapter 11 protection. The home-style roast

chicken takeout chain expanded far too fast, growing from 34 stores in 1992 to 1,143 by 1997. But it was its franchisee-financing scheme that ultimately undid it. The company, which was headed by former Blockbuster Video execs Scott Beck and Sam Nadhir, has been struggling to restructure all year. Battered with an Oct. 17 deadline for both its bank credit line and \$283 million in senior debt, it could no longer star the heat.

ET CETERA...

- A shareholder suit against Walt Disney over Mike Ovitz's severance was dismissed.
- Lycos acquired online service Wired Digital for \$100 million in stock.
- Candant canceled its Prudential deal, and its American Bankers buy looks shaky.
- Raytheon cut 5,300 jobs after a disappointing quarterly earnings.



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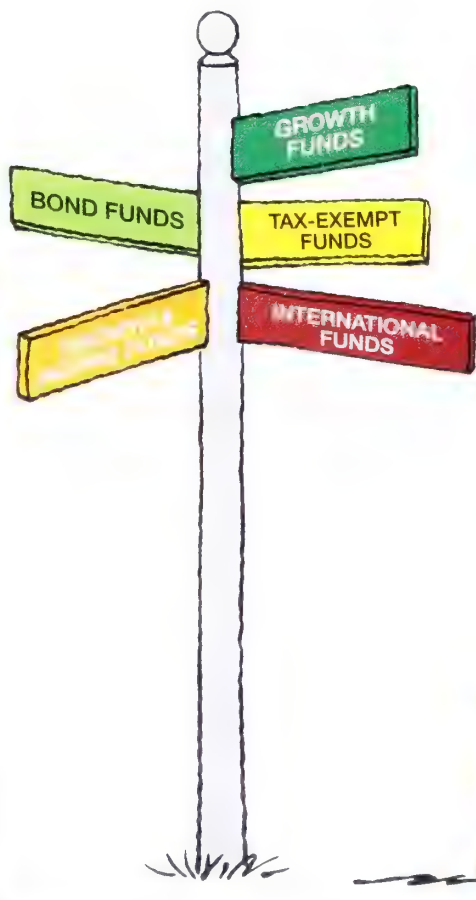
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EDITED BY OWEN ULLMANN

UNIONS: LABORING MIGHTILY TO AVERT A NIGHTMARE IN NOVEMBER

It's an election-night scenario that makes AFL-CIO President John J. Sweeney sweat: Democrats disgusted with Bill Clinton stay home while a massive turnout of outraged Republicans gives the GOP its first filibuster-proof Senate since the Teddy Roosevelt era. That prospect is behind a furious ground war labor has launched to avert disaster on Nov. 3. Unions hope to stop the GOP from picking up five Senate seats. That would give Republicans the magic 60 needed to undo the delaying tactics used by Dems to block antilabor bills. Top goals include protecting prolabor incumbents Barbara Boxer in California and Harry Reid in Nevada. Strong turnout could also help Dems cling to seats in South Carolina, Wisconsin, Kentucky, and Kansas—and unseat GOP incumbents in New York and North Carolina. Frets top Hill Democratic strategist: "If you don't turn out, we lose."

WINNING PAVEMENTS. Losing would be devastating for labor. The GOP would have the leverage to pass legislation such as bills to limit unions' political spending, curb compensatory overtime, and gut the Occupational Safety & Health Administration. "If they got to [Senate Majority Leader Trent] Lott [R-Miss.] could've a lot of his agenda that he's blocked from doing now," says AFL-CIO Legislative Affairs Director Peggy Taylor. At the same time, it would be easier for Republicans to team up with Democratic moderates to override a Presidential veto. The AFL-CIO's plan: Ignore the sex scandal and drive its 13 million members to the polls by focusing on hot-button issues Democrats get high public marks, such as protecting Social Security and improving health care. But instead of winning the case through a 1996-style blitz on the airwaves, the campaign will be fought on the streets. The federation has budgeted \$5 million for TV ads, while

pouring at least \$18 million into a get-out-the-vote drive. Some 300 paid activists will lead the effort, vs. 135 hired in '96. They're working with locals to get thousands of volunteers to make house calls and visit work sites. To maximize its impact, the AFL-CIO also is focusing on just 8 Senate races and 45 tight House contests—down from over 100 two years ago. Labor has given up hopes of recapturing the House for the Democrats, but it's trying to keep losses in the single digits.

Labor's key battleground: California, where staunch ally Boxer is slipping behind her GOP rival, State Treasurer Matt



BOXER ON THE STUMP: A must-hold seat

Fong, among likely voters. To help Boxer, Democratic gubernatorial nominee Gray Davis, and a half-dozen Democrats in close House contests, labor is trying to repeat its organizational magic of last June. That's when a surprisingly large union vote doomed a state ballot initiative to curb union spending on politics. By late October, labor officials hope to have 8,000 volunteers on the streets. "We don't talk about the scandal, but we do tell our members that [overall] turnout is expected to be lower, so our vote can make the difference," says Arlene Holt, an AFL-CIO official working in California.

The AFL-CIO is supplementing the door-to-door and phone-bank campaigns with mass mailings that compare candidates' positions on issues such as trade and Social Security. Already, every union household in the state—1.4 million adults—has received two mailings. They'll get up to four more by Nov. 3.

Labor's push has the GOP worried. "It rivals any ground war we've ever seen," says the National Republican Congressional Committee's Mary Crawford. The GOP is countering with a TV barrage costing over \$30 million. But if labor mobilizes its troops on Election Day, the Dems may yet avert disaster.

By Aaron Bernstein and Richard S. Dunham

CAPITAL WRAPUP

HANGING JUDGE McCONNELL?

If the House impeaches President Clinton, his fate in the Senate will be managed by one of the chamber's most recent partisans. When a new Congress convenes next year, Senator Mitch McConnell (R-Ky.), who heads the National Republican Senatorial Committee, will become chairman of the rules panel that would oversee a trial. McConnell, who led the fight to pass campaign-finance reform, will replace the courtly John Warner (R-Va.), not known for hardball politics.

INDEPENDENTS SWING RIGHT

► While both parties are focused on delivering their loyalists to the polls on Nov. 3, close elections will be decided by independent voters. And that could be bad news for Democrats. In an Oct. 4-6 Zogby International poll, independents, by 3 to 1, say they're less likely to back a candidate who voices support for President Clinton. Zogby, a nonpartisan polling firm, says most independents also want Republicans to keep their congressional majority.

THE VIRTUAL RALLY

► It's the first cybermarch on Washington. Two public advocacy groups—Third Millennium and Economic Security 2000 Action—are rallying citizens to back Social Security reform over the Internet. As of Oct. 9, people can click www.march.org to urge pols to raise the retirement age to 70, set up benefit means-testing, and let individuals invest part of their payroll taxes. Hoping for 250,000 E-mails, the groups plan to route them all to Capitol Hill on one day in January.

THE CITIES ARE SINKING

Japan's next big financial mess is here

Among the world's great metropolises, no city seems better managed or more prosperous than Tokyo. The smoothly running subway, the immaculate parks, the unobtrusive police booths at every major corner, the absence of dangerous slums, the well-maintained schools—it all gives the impression of a carefully planned, well-tended place, a marvel of urban engineering. Western visitors are always hard-pressed to find evidence of Japan's crisis when they roam the Tokyo streets, taking in the sights of the Ginza or sipping latte from one of Starbucks' newest outlets.

Yet looks can be deceiving. In the past few days, Tokyo city officials have come clean on their own version of the Asian crisis—a gargantuan budget emergency that could cost billions to fix. And Tokyo isn't the only Japanese city in need of some major financial renewal. In fact, the news coming out of Japan's prefectural and municipal offices is fiscally terrifying. Briefly put, the local Japanese governments are broke, or very nearly so. They are going through a financial collapse that poses another major challenge besides the banking crisis (table). And if the central planners in Tokyo think that Japan's city halls can finance new public works to revive the economy, they may be in for a very nasty surprise.

"HIGHLY DANGEROUS." To get a sense of what's going on, it's important to realize the role that the prefectures and city governments of Japan have played in building public works, keeping construction companies prosperous, and generating jobs. For decades, the Ministry of Finance has shuffled off much of Japan's deficits onto the local governments. The Diet would order up some public works, and the central government would foot the bill for many of them. But the governments of Tokyo,

Kyoto, Osaka, Nagasaki, and other localities would also issue bonds in their own name to pay for many of the new fishing ports, harbors, and other projects of questionable value.

It was a clever way to keep a lot of the spending off the books of the central government. Says Tokyo University government-finance specialist Naohiko Jinno: "It's somewhat like the way big Japanese companies use their subsidiaries to keep their own finances in shape." Since 1992, the government has budgeted \$300 billion for public works. Local governments were told to come up with 28% of that amount.

The freewheeling spending benefited lots of politically connected companies and gave many mayors big budgets to play with. But now local officials are in a panic because the overspending has brought them to the brink: The governments of Tokyo, Osaka, and Kanagawa, the prefecture for Yokohama, have edged close to insolvency and may have to fall under central government supervision to sort out their debt mess. It's as if New York, Chicago, and Los Angeles all reported acute fiscal crises at the same time. "We are moving into a highly dangerous, critical



condition," concedes Tsutomu Ushioda, budget official with the Tokyo metropolitan government.

Not only are these cities taking huge hits from sliding corporate and personal tax revenues but they are still being strong-armed by the central government to assume more debt to help bankroll a \$124 billion public-work package announced last April. Yet few regional governments now have the stomach to borrow more. Already Japan's local government debt is roughly 2% of gross domestic product, well over twice the level for regional governments in other industrialized nations. Debt at five of the most leveraged prefectures comes to \$90 billion. Some of the figures make Japan's cities look like wobbly emerging-market states. In 1991, Kanagawa ran a budget deficit equal to nearly 24% of its annual expenditure. Nagasaki, Hyogo, Akita, and Kochi are in similar straits.

Moreover, many of these cities are now waging a quiet revolt against the central government. Recent legislation has given the localities a little more autonomy from Tokyo, and they are using that wiggle room to delay the project

Japan's Local Debt Crisis

PREFECTURE	TOTAL DEBT * (BILLIONS)	DEBT AS % OF LOCAL ECONOMY
TOKYO	\$58.4	81%
OSAKA	19.6	66
KANAGAWA	10.4	47
KOCHI	1.8	99
AKITA	1.2	99

*Year ending 3/97

DATA: MERRILL LYNCH & CO.



WHERE CAN TOKYO CITY GOVERNMENT FIND COVER?

ilar central government bonds has widened to 50 basis points—the largest gap ever seen, according to the Japan Local Bond Assn.

Now the cities have to raise money with new levies. The Osaka government may hike the entrance fee for public high school students tenfold to cover a steep drop in tax revenues. In Tokyo, politicians are thinking about scrapping the “silver pass,” or free ticket on many types of public transportation. Little by little, ordinary Japanese are going to have to shoulder more of the costs of social services until governments can lower their debt levels to sustainable levels.

As the recession deepens, it may even be necessary to bail out Japan's cities. But that presents a conundrum: If the central government

needs to spend billions saving the banking system, how is it going to come up with extra sums to save Tokyo, Kanagawa, and the other metropolitan areas?

Also, if the cities call a halt to their public works, then Japan's construction companies—already well in arrears on loan payments to the banks—could get into deeper trouble. And that, of course, would cause more woe for the banks. A separate issue: As banks start calling in loans of all kinds to shore up their capital bases, local companies will be starved for credit and be forced to shutter plants and lay off workers. That pain will reach the prefectures in the form of even lower tax revenues. Slowly but surely, the crisis is making its presence felt in every city, town, and hamlet.

By Brian Bremner and Miki Tanikawa in Tokyo

the central planners think local governments can finance a round of public works that might revive the economy, they're in for a nasty surprise

have been forced to budget for. The public-construction starts sponsored by the central government are going steady, those launched by local governments have dropped 20% this year from 1997. As a result, Finance Minister Kiichi Miyazawa's pledge that the government would spend its way out of recession may not prove true at all. That's especially troublesome since the big Oct. 1 rally in the Nikkei was based partly on hopes of a huge spurt in public-works spending. “There's considerable doubt that this one remaining source of growth in the economy will have any more than a modest impact,” figures analyst Ron Bevacqua of Merrill Lynch & Co.

To tell the truth, the government should be recycling Japan's vast savings into public concert halls, resort

spas, and generous social services. For one thing, it does a lousy job of allocating the money. In the Tokyo area, some \$30 billion has been dispensed to build such projects as a lavish metropolitan headquarters and two international exhibition centers that were unneeded, notes Yasunobu Watanabe, a Tokyo prefectural assemblyman and member of the Japan Communist Party. “They should have reviewed, frozen, or canceled these projects,” says Watanabe.

LARGEST SPREAD. The spending spree has left Tokyo prefecture with \$2.2 billion in debt-service costs this year. Those obligations will rise to \$3.7 billion in 1999, and the government will be hard-pressed to cover them. In a sign that investors are getting edgy about all the local debt in Japan, the spread between 10-year municipal bonds and sim-

MALAYSIA

MAHATHIR COULD GET MORE THAN HE BARGAINED FOR

At November's APEC summit, he'll come under heavy pressure

The scene in the cramped, tropical courtroom on Oct. 5 in Kuala Lumpur was as farcical as it was cruel. Judge Augustine Paul, waving his long bony fingers as he spoke, denied bail to cashiered Deputy Prime Minister Anwar Ibrahim. The defendant wore a neck brace and bore bruises from what he says was a police beating in jail, where he awaits trial on charges of sodomy and abuse of power. One of his lawyers complains: "Right now, he's in limbo."

And so is Malaysia. Prime Minister Mahathir Mohamad, 72, has alienated his recession-struck country from the rest of the world by imposing capital controls and by jailing Anwar, the country's strongest proponent of economic reform. Now, Mahathir and his policies are coming under pressure from all sides. As the economy worsens, a *reformasi* movement smolders in the streets of the capital while multinational corporations are starting to complain. His biggest challenge may come on Nov. 17-18, when he hosts an economic summit of leaders from Asia, Japan, and the U.S. The next few weeks will test Malaysia and the isolationist strategy that Mahathir espouses to save the region's economies.

STREET-CLEANING. A month ago, the Asia-Pacific Economic Cooperation (APEC) summit was not Mahathir's major worry. At that time, with Malaysia in recession and senior members of the ruling party, the United Malays National Organization (UMNO), starting to question Mahathir's 17-year Premiership, there were fears that Anwar would stage a political coup. Anwar was already preaching open markets and defying Mahathir's efforts to blame the recession on foreign speculators. On Sept. 2, Mahathir sacked Anwar as Deputy Prime Minister and Finance Minister and had him arrested



18 days later. Anwar says the charges against him are fabrications.

By hosting a smooth-running APEC summit, Mahathir would like to regain international credibility. He hopes that by banishing protesters and beggars from the streets, he can win at least a grudging acceptance for his contrarian economic plan. Still, he is likely to continue his harangue against international capital markets—the very issue that pitted him against the West and against Anwar. The burning question, says one

diplomat: "How is Mahathir going to play it, and what dead cat is he going to throw on the table?"

The economy is still deteriorating despite the capital controls Mahathir has hoped would stop the slide. The economy will shrink 7% this year, and the ringgit is already trading at a 13% discount on the black market. It could get worse if U.S. and European multinationals such as Intel Corp. and Microsoft Corp. lose confidence. Companies are leaving yet, but some projects are on hold. Mahathir has promised that companies will be able to repatriate profits and dividends. "From our standpoint it's wait and see," says Tom Freita, president of the American Malaysia Chamber of Commerce.

SYMPATHY. When Mahathir opens the APEC summit, he could get more than he bargained for. Visiting heads of state, Malaysia-based foreign executives, and Anwar supporters alike all have their own agendas. In meetings with the Prime Minister in early October, foreign business leaders urged him to tone down his anti-Western rhetoric. They also sought assurances that capital controls will remain in place no longer than mid-1999 and that he will welcome back the financial-services companies I shooed away by imposing the controls.

The reform movement also wants a hearing, and it may get one from the visiting heads of state. Anwar's wife, Azizah Ismail, is its de facto head. She wants to make her husband's case an international human-rights issue. She has requested meetings with President Clinton and other visiting leaders. Already she has the sympathy of Western

BLACK EYE

Anwar's arrest may lead Clinton and other visiting leaders to give the reform movement a sympathetic ear

well as Asian governments. President Joseph Estrada of the Philippines and B.J. Habibie of Indonesia have hinted that they may boycott the summit. Both are friends of Anwar.

With world leaders coming to town, Mahathir has a great opportunity to ease some damage control. Anwar's trial starts just before they arrive, and Mahathir could use their presence to ease up on him. He could reassure investors by setting a deadline for ending capital controls and taking a more conciliatory stance toward the West. But chances are he won't reform and that Malaysia will remain in limbo until its crisis forces a wrenching change.

By Sheri Prasso in Kuala Lumpur

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EUROPE

A CONTINENT IN DENIAL?

The crisis may hit Europe harder than it expects

Until a few months ago, Europe seemed an oasis of steady growth in an increasingly shaky world. Whispers of inflation picking up in the U.S., plus Asia's long sickness, highlighted the Continent's many fundamental strengths, from ongoing corporate restructuring to deficit-cutting to a cyclical recovery that was just gathering steam. The prospect of monetary union made the optimism even livelier.

Now, the picture has grown fuzzy. Although many of the reasons for confidence in the Old World's economy remain sound, Europe faces a host of unknowns. Fears of huge bank losses from Russian loans and flagging exports to Asia have caused Continental stock markets to plunge since August. Already, economists have ratcheted down growth forecasts for this year and next. Uncertainty over the fallout on Europe from the world financial crisis could put a damper on everything from consumer spending to capital investment.

POLITICAL CONCERNS. The big danger is that Europeans are underestimating how hard they will be whacked by the world financial crisis. HSBC figures that 38% of European exports go to areas vulnerable to the crisis, vs. 49.5% for the U.S. So far, the Continental consumer recovery has helped offset the hit to exports. But that could change quickly. German exports will be highly vulnerable if the mark continues to rise.

The emerging-markets crisis has already depressed executive sentiment: Business confidence has dropped in recent surveys in Italy, France, and Germany.

Bank losses could further aggravate the situation. Besides UBS, which will lose \$700 million from exposure to U.S. hedge fund Long-Term Capital Management, Germany's Dresdner Bank, Britain's Barclays, France's Société Générale, and others



have taken profit hits from emerging-market investments. More bad news could make lenders edgy. "The problem with all this will be if the banks get nervous and cut off credit lines," worries Mark Hoge, an analyst with Credit Suisse First Boston in London.

The longer-term concerns are political. Economists fear that center-left governments may spend more freely next year to stimulate their economies, pushing budget deficits in places such as Germany and France close to the limit of 3% of gross domestic product mandated under EMU. Another concern: that governments beholden to labor constituencies may start pushing up European wages again. Goldman, Sachs & Co. estimates that unit labor costs in

half-point cut in Spanish interest rates to 3.75%, and comments at the International Monetary Fund meeting in Washington by Bundesbank President Hans Tietmeyer suggesting that Germany might also consider a rate cut. The fact is, Europe will get a big boost from falling interest rates even if Tietmeyer does nothing. That's because under European Monetary Union, short-term rates throughout the Continent are expected to converge at Germany's low 3.3% level.

On average, Continental rates will come down by nearly half a point as Spain, Portugal, Ireland, and Italy fall into line. And some analysts predict the new European Central Bank may slash rates further when it takes over monetary policy on Jan. 1, to keep a too-strong euro from hammering exports.

Yet Europe is not immune from the deflationary forces that are plaguing the rest of the planet. Its economy may remain relatively healthy. But until the effects of the global crisis can be assessed more certainly, the market mood swings and changing forecasts are likely to continue.

By Thane Petersen in Frankfurt, with bureau reports

Can Europe's Economy Hold Up?

YES

GROWTH Economists figure the European economy will expand by about 2.5% next year as consumer spending rises.

INTEREST RATES Short rates will fall nearly half a point by Dec. 31 as they converge in preparation for monetary union.

FISCAL LOOSENING After several years of tight finances, governments can spend a bit more without swelling their deficits.

NO

BUSINESS CONFIDENCE Executive surveys show sentiment turning down. That could cause a pullback in investment.

EXPORTS Thanks to Asia, export growth in France and Germany this year could be around half what it was in 1997.

WAGE DEMANDS Eurozone unit labor costs may rise now that center-left coalitions are in power across the Continent.

DATA: MORGAN STANLEY DEAN WITTER, GOLDMAN SACHS & CO., HSBC GROUP

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SWEDEN

COMPANIES MAY VOTE WITH THEIR FEET

As the government moves left, business ponders moving out



TOUGH LESSON: Lavish social benefits can't make up for crippling taxes

When Swedish telecommunications giant Ericsson announced a long-awaited management shakeup on Sept. 30, Chief Executive and President Sven-Christer Nilsson was chagrined at the reaction. Instead of concentrating on the young hotshots he had chosen for his new team, the press played up the news that Ericsson would be moving its European headquarters and finance arm to London. "I was so amazed by the force of this issue," says Nilsson.

The CEO vows that Ericsson's official domicile will always be Sweden. But the prospect that the country's biggest private employer plans to shift some key jobs overseas touched a nerve. Sweden's astronomical tax rates, restrictive labor laws, and supergenerous welfare programs have long made it a tough place for business. Unless the country's business climate improves, more jobs, capital, and talented workers could flee.

Industry's hopes for government measures to boost competitiveness have been dashed by the Sept. 20 elections, which forced the ruling Social Democrats leftward. Lacking a majority in parliament, Social Democratic Prime Minister Göran Persson must depend on the formerly communist Left Party

and the Greens. This shaky alliance may not last, but it comes at a critical time for Sweden, which is agonizing over whether to join the European Monetary Union. Execs fear Sweden will be at a disadvantage to EMU members if it stays out too long. But the Greens and the Left are fierce foes of the single currency, arguing it would let a centralized authority meddle with Sweden's beloved welfare system.

WHY BUSINESS IS SQUEAMISH IN SWEDEN

- ▶ The world's highest taxes make it hard to recruit international staff and retain local talent.
- ▶ Inflexible labor rules make adding or dismissing workers a nightmare.
- ▶ Business fears that the government may try to shorten the workweek.
- ▶ Executives worry that unless Sweden joins the European Monetary Union soon, it will suffer from higher interest rates, a volatile currency, and lost competitiveness. But government allies are anti-EMU.

DATA BUSINESSWEEK

Until recently, business was banking on economic growth in the 3% range for the coming two years. But the turmoil in emerging markets is likely to slam Swedish companies, which are among the world's most adventurous investors. At the same time, the 34% drop in the Swedish stock market since the July 20 high could chill consumer spending.

Top managers had hoped that Persson, who has served as Prime Minister since 1996, would move ahead with tax cuts and other measures to make Sweden a more attractive place for investment. Now such plans are probably on hold for a year or two. So Swedish business will continue to cope with the world's highest ratio of taxes to economic output—54.7%. Economists say that the tax regime and the lavish welfare state that goes with it are largely responsible for Sweden's lagging behind the OECD in economic growth by an average of more than one percentage point for the last three decades.

BRAIN DRAIN. Taxes are one factor that forces companies and wealthy individuals to consider moves outside Sweden. The corporate tax rate of 28% is not so bad, but the 59% top marginal rate and 35% payroll taxes are killers. Any one earning more than about \$62,500 pays this top rate. Sweden also slaps a wealth tax of 1.5% on bank accounts and property worth more than \$120,000. Such punitive taxes make it almost impossible for Swedish multinationals to recruit talented foreign executives and technical researchers to Sweden. Taxes are also driving away wealthy Swedes as well as managers and engineers.

Sweden's high taxes are costing it not just brains but money. Swedish citizens may have as much as \$40 billion parked in London, Switzerland, and other financial centers. Klas Eklund, chief economist at bank SEB in Stockholm, thinks the shrinking tax base could force the government to rethink some of its policies.

Executives cling to the hope that the rigors of the global economy will force Sweden to wake up. But it won't be easy to change the country's politics. Some two-thirds of Swedish citizens depend on the public sector for their main source of income. They are understandably reluctant to vote for any cuts. Until they do, business will pay most of the price.

By Stanley Reed, with Ariane Sains, in Stockholm



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RUSSIA

WHAT DISASTERS LIE AHEAD IN MOSCOW?

Rash policies could mean a hard winter—and social unrest

A new joke is making the rounds in Moscow: "For too long we have been standing at the edge of the precipice," it goes. "Now we are taking a great leap forward."

That's surely how things look to holders of Russian debt. Barely a month after defaulting on \$40 billion in domestic Treasury bills, the Kremlin may be only weeks away from defaulting on payments on \$150 billion in hard-currency sovereign debts. By the end of December, Russia must pay interest and principal totaling more than \$3 billion on Eurobonds, restructured Soviet-era debt, and loans from international financial organizations. An additional \$19 billion falls due next year—about three-fourths of it owed to foreign creditors.

Where is Russia going to get the money? Finance Minister Mikhail Zadornov says the government will tap its \$12.5 billion in hard-currency reserves to make this year's payments. But reserves won't cover next year's due bills and the International Monetary Fund has sworn off any further assistance for now. The prospect of bigger losses for investors grows more likely by the day. Here's a look at how deep Russia's crisis could go.

How real is the threat of default?

Very real. The Russians would have trouble paying their debts even if the economy were growing, and it's shrinking fast. Tax receipts have dropped by nearly 50% since July, to about \$450 million in September. Already, the Kremlin has had to beg for an extension on \$600 million in interest payments on Soviet-era debt due to Western governments. Russia's hard currency debt is now rated the riskiest in the world.

What does Russia have to lose from more defaults?

Defaulting on foreign-denominated sovereign debt would have grave consequences. Apart from destroying Russia's chances to return to international markets, a default could prompt creditors to make use of foreign courts to seize Russian property, including assets of energy companies such as Gazprom. Lehman Brothers Inc. recently won court orders freezing \$128 million in the British units of three Russian banks



RUBLE MANIA Russia is in the eye of a financial hurricane. The government plans to nearly double the money supply

NEW BILLS: BY YEAREND, THE INFLATION RATE COULD EXCEED 300%

that failed to honor foreign exchange contracts. But Russia is eager to stay current on its outstanding \$16 billion in Eurobonds. Most analysts predict that the government will dig into its reserves to make its Eurobond payments, which total nearly \$1.9 billion through the end of next year.

What about other debt holders?

The best they can expect is restructuring. The Kremlin is likely to seek a

restructuring deal on Finance Minister bonds covering the debts of the old Soviet state bank. These bonds have been popular with institutional investors. The government has never missed a payment, but there's little hope it can come up with the \$1.3 billion principal on a bond that matures next May. Other creditors include the French and German governments and the IMF, which is owed more than \$5.4 billion over the next 15 months.

If Russia can restructure its debts, couldn't it muddle along for some time?

No. Russia is in the eye of a financial hurricane. Central Bank Chairman Viktor Geraschenko is printing money. He plans to nearly double the money supply by Dec. 31. The government itself acknowledges that the inflation rate could reach 200% by yearend.

What is the government planning to do, besides print money?

One of its first moves was to reestablish the state liquor monopoly. The government will also force exporters of oil, gas, and other commodities to convert more of their hard currency earnings into rubles. But after four weeks in office, Prime Minister Yevgeny M. Primakov still hasn't offered a comprehensive plan to pull Russia out of its economic morass.

So what happens next?

Many analysts think Russia is heading for a winter of economic hardship so severe that Primakov's Cabinet—and possibly the Prime Minister himself—could be discredited and forced from office in a few months. Optimists say Russia might then agree to tough monetary measures. Surprisingly, ordinary Russians might not mind. A recent poll shows that only 25% of Russians support printing money to pay back wages, while 57% oppose it as inflationary. But pessimists worry that political instability could lead to social unrest, or worse.

By Carol Matlack in Moscow



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Leroy Magaña,
Product Design Engineer,
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BEIJING'S CHARM OFFENSIVE IS GIVING TAIWAN THE JITTERS

After a five-year freeze in relations, Taiwan and China will finally start talking again at a high-level meeting in Shanghai on Oct. 14. In the runup, both Beijing and Taipei have made a number of conciliatory gestures. Taiwan canceled potentially provocative war games scheduled to start on Oct. 12. Beijing dropped its insistence that Taipei must accept its "one China" policy of eventual reunification as a precondition for talks. For the moment, it has agreed to leave aside thorny political topics and just discuss workaday issues such as fishing rights.

Now, China is offering another sweetener. Foreign Minister Tang Jiaxuan promised Taiwan "greater autonomy than Hong Kong" if it reunites with the mainland. Analysts labeled the plan as "one country, three systems." Unlike Hong Kong, Taiwan could, say Chinese officials, keep its own army, and its leaders could serve in China's government.

"A LOT OF PRESSURE." That's a big reversal from 1995 and 1996, when Beijing frightened the world by testing missiles in the Taiwan Straits. But the changed tone serves China's interests. Beijing doesn't want distracting rows as it tries to implement painful economic reforms. Indeed, it needs continued access to Taiwanese capital and knowhow more than ever. Besides, Beijing is eager to build on the diplomatic gains made during President Bill Clinton's June summit—for instance, by getting permanent most-favored-nation status from the U.S. and support for early World Trade Organization entry. Getting Taiwan on a reunification track would also help Jiang consolidate his power and secure his historical legacy.

Taiwan's business community, which Beijing is eagerly wooing, wants closer ties. More than 30,000 Taiwanese-funded enterprises have invested about \$35 billion in China. But two years ago, Taipei restricted high-tech and infrastruc-

ture investments and limited those in other sectors to under \$50 million. Business argues that Taiwan companies are in danger of being locked out by rivals. "Many world-class international companies have started to invest in petrochemical projects in the mainland. We fear we will lose our opportunity if we invest later," says Formosa Plastics Group Chairman Wang Yung-ching.

To many Taiwanese, however, Beijing's charm offensive is alarming. Taipei is cool to the "three systems" idea, but it is in a bind. The suggestion undercuts Taiwan's main objection to earlier proposals: that the mainland would have treated it just like the small city-state of Hong Kong. "The peaceful approach puts a lot of pressure on us," says Andrew Yang, secretary general of the Chinese Council of Advanced Policy Studies in Taipei.

NO CONSENSUS. Reunification is a hot-button issue in Taiwan's politics. The ruling Kuomintang and President Lee Teng-hui prefer to keep their distance, favoring eventual reunification once China has democratized and caught up to Taiwan economically. But the main opposition, the Democratic Progressive Party, wants independence. Analysts say recent DPP electoral gains and the prospect that its candidate could win the presidency in 2000 pushed Beijing to parlay now. But Taipei can't talk politics with Beijing

because of the lack of consensus at home. "Any leader that does this would be immediately attacked," says Lin Chong-pir, vice-chairman of Taiwan's Mainland Affairs Council.

All the same, time is working against Taipei. President Clinton's June public statement of U.S. opposition to Taiwan independence or U.N. membership was a big setback. Now just 27 countries recognize Taiwan. And it will soon have even fewer friends if Beijing continues to make reasonable-sounding offers that Taipei can't accept.

By Jonathan Moore in Taipei



LEE: Keeping his distance

GLOBAL WRAPUP

CHINA SHUTTERS FINANCE FIRM

► Reflecting growing woes in China's financial sector, the central bank abruptly closed Guangdong International Trust & Investment Corp., which owes over \$450 million to foreign lenders. An Oct. 6 announcement said the move was to protect GITIC's creditors and that Beijing would make good on GITIC's loans.

GITIC was one of 10 investment trust companies set up to allow China to tap global capital markets. It was heavily invested in the volatile real es-

tate market, which fell sharply this year. Since the start of 1997, the authorities have shut several smaller institutions as they try to deal with bad loans throughout the financial sector.

SOUTH AFRICA SPLITS OVER RAID

► South Africa's bungled intervention in neighboring Lesotho on Sept. 22 is roiling the government. Even senior military officers joined the chorus of criticism, saying intelligence failures led to the debacle, which provoked chaos, instead of restoring calm, and left over 70 dead. The incident, ana-

lysts say, highlights serious flaws in South Africa's government and military, where suspicions run deep between apartheid-era holdovers and appointees of President Nelson Mandela's African National Congress.

Businesspeople are up in arms because most of the buildings torched and looted during riots in Lesotho's capital, Maseru, were South African-owned. They were angered when Deputy President Thabo Mbeki, who went on TV to defuse criticism, failed to promise compensation for their losses, which total \$165 million.

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HEY, THINGS WERE TOUGH ALL OVER

With markets tumbling, the BW 50 had a dicey half-year, but some still came out ahead

Back in March when we compiled the second annual BUSINESS WEEK 50, razor maker Gillette Co. looked hot. It was about to launch a revolutionary triple-bladed shaving device, the Mach3, and a steady sequence of double-digit earnings gains had sent its stock to a record high.

But by September, Gillette had slipped. Weakness in emerging markets—34% of its sales come from outside the U.S. and Western Europe—plus the costly ramp-up of the Mach3 had buffeted earnings and, in turn, the stock. Now trading at around 39, the consumer-products giant is down 37% from its 52-week high of 62.

Like many fast-growing companies with global ambitions, Gillette found out that what wowed investors last spring only made it a bigger target for those dumping shares in the summer and fall. Investors, stung by reports of cratering markets in Russia and Asia, have moved swiftly to cut overseas exposure, even if it means abandoning companies that have delivered years of solid earnings gains. That reversal has been particularly painful for the banks and other financial firms that rode the bull market, acquisitions, and low interest rates to tremendous gains in recent years—a performance that won them a prominent place on this year's BW 50.

HALF DOWN. The result: In the six months since we culled out a list of the best-performing members of the Standard & Poor's 500-stock index, the stocks of many of our growth companies have deteriorated. The BW 50's overall 9.5% decline was worse than the S&P 500's 7.2% drop but better than the Dow Jones industrial average, which fell 11.3%, and the Russell 2000 benchmark of small stocks, which lost 23.4%. Though many technology companies continued to do well, more than half of the 50 are posting lower stock prices than they were in March. (Both Standard & Poor's Corp. and BUSINESS WEEK are owned by The McGraw-Hill Companies.)

Of course, when you hitch your wagon to hot performers, as we did in creating the BW 50, there is a danger unforeseen events can send you tumbling. After six months, the average price-to-earnings ratio for the 50 stocks is 28,

well above the S&P 500's average p/e of 24. That could expose these stocks to further sell-offs. But over the long term, investors still clearly expect outside gains from the 50.

BRIGHT SPOTS. The list favors companies that consistently performed the best based on improvement in sales, earnings, and total returns over a one-year and three-year period. Two more ratings—return on equity and net margins—were added to measure how well management runs the business. Companies are also weighted by sales to acknowledge that it's easier to grow from a smaller base.

Total performance for the group is calculated as if one share of each stock had been purchased. In the past six months, that's been a winning formula.

Last year's BW 50 rose 24.7% in its first six months—vs. 16.5% for the S&P 500—and jumped 47.7% for the year, again outpacing the 500's 34.7% climb.

Even amid the gloom of the past six months, there were bright spots. Technology companies dominated the list of BW winners. The top performer over the six months was Dell Computer Corp., up 85%. By combining lean manufacturing with smart marketing, Dell has far rendered itself immune to the domestic slowdown. "They are expanding into new markets, there is no weakness in demand, the margins are stable," says Alan Bond, president and chief investment officer of institutional investor Bond Procope Capital Management.

Cisco Systems Inc. also continued its stellar run, jumping 44%. Outperforming rival computer networkers, Cisco bucked Asian woes in mid-September when it announced a 50% rise in sales to Singapore. Several other technology stars—EMC, Compaq, Microsoft, Sun Microsystems, and Intel—parlayed leadership positions into stock gains.

Others that defied the market downturn capitalized on areas where the economy remains strong. Schering-Plough, maker of the No. 1 allergy drug

THE BUSINESS WEEK



How Each Company Performed

BUSINESS WEEK 50 RANK	COMPANY	PERCENT CHANGE PRICE (3/20/98 - 9/18/98)
2	DELL COMPUTER	85%
3	CISCO SYSTEMS	44
8	EMC	41
17	GAP	33
34	SUNAMERICA	32
5	COMPAQ COMPUTER	32
1	MICROSOFT	29
30	OMNICOM GROUP	20
11	SCHERING-PLOUGH	19
44	HOME DEPOT	17
20	SUN MICROSYSTEMS	13

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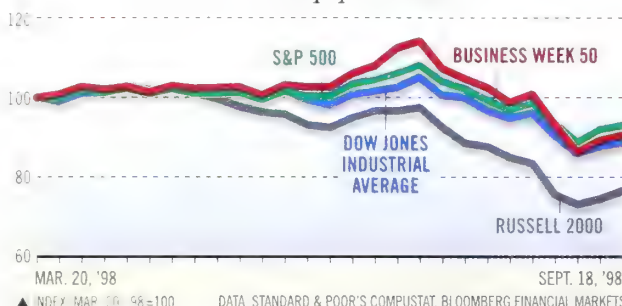
Claritin, looked solid, as did Viagra manufacturer Pfizer. Strong consumer confidence helped Gap and Home Depot to double-digit stock hikes. And Guidant Corp., which makes a device used in coronary surgery, continued to steam ahead.

Indeed, for a while the BW 50 as a group looked as if it might weather the market turbulence quite well. As recently as late August, the BW 50 was leading all three indexes—the Dow Jones, Russell, and S&P 500—by a significant margin. But then global stocks tumbled and currencies dropped. The continued global financial turmoil has led to a rout in the shares of many finance companies. Since the BW 50 is weighted far more heavily toward those stocks than the broader market indexes, it was hit hard. Some 38% of the current BW 50—19 companies—are banks, insurers, and brokerages. That compares with 77 companies, or 15%, of the S&P 500. As a group, the financial stocks of the BW 50 fell 19.8% for the six months.

Brokerages such as Merrill Lynch, Travelers' Salomon Smith Barney division, and Morgan Stanley Dean Witter were among the most affected, as they racked up trading losses. By September, S&P had placed Lehman Brothers Hold-

THE BUSINESS WEEK 50—SIX MONTHS LATER

Our corporate stars trailed the S&P 500 slightly, but beat other popular indexes



ings Inc., the smallest of the bunch, on Creditwatch with negative implications, and announced it would look into many of its brethren. Lehman, the worst-performing of the financial stocks in the BW 50, dropped 54% since March.

OIL, TOO. Not all the blame can go to the money sector, though. Stubbornly low oil prices pushed stock prices down 32.1% and more at oil service providers Schlumberger Ltd. and Halliburton Co. A profit warning on overseas turmoil and a slowdown in demand for Year 2000 fix-ups cut Computer Associates International Inc. by 41%. And the BW 50's biggest loser was Parametric Technology Corp., which makes engineering software. Its 69% decline stemmed from management mix-ups and a bumpy shift to an Internet-based product.

Will the next six months spell a rebound for the 50 or more pain? Daily market gyrations indicate continued volatility, if not a bear market. Indeed,

the gap between the S&P 500 and the BW 50 has grown even wider in the past three weeks—as of Oct. 5, the BW 50 was down 16.9% from March 20, compared with negative 10.1% for the S&P 500. The slide of financial-service firms was one factor, but the slump also caught up with some stronger performers. Guidant has given back almost all its gains, for instance.

Moreover, the wave of acquisitions that helped prop up the stocks of industry consolidators seems to be dwindling. Although a record \$1.3 billion in deals have been announced this year according to Securities Data Co., September stalled out at only \$45 million.

These concerns, plus worries about the impact a not-so-merry Christmas shopping season may have on retailers and personal-computer vendors, will play out between now and next March, when we rejigger the list. But don't be surprised to see some of the same blue-chip stalwarts show up for the third year running. Analyst Laszlo Birinyi of Birinyi Associates notes that through all the recent gyrations, steady performers such as Dell and Microsoft have attracted investor dollars. "We continue to see the biggest interest in large, significant, well-known names," he says. "In a market like this, you can't own enough of the winners—but, it seems, you also can't avoid owning some of the losers."

By Nanette Byrnes and Frederick Jespersen in New York

THE BUSINESS WEEK 50

BUSINESS WEEK 50 RANK	COMPANY	PERCENT CHANGE PRICE (3/20/98 - 9/18/98)	BUSINESS WEEK 50 RANK	COMPANY	PERCENT CHANGE PRICE (3/20/98 - 9/18/98)	BUSINESS WEEK 50 RANK	COMPANY	PERCENT CHANGE PRICE (3/20/98 - 9/18/98)
28	GUIDANT	11	33	PROGRESSIVE	-12	29	PACCAR	-31
4	INTEL	10	47	CLEAR CHANNEL COMMUNS.	-14	18	SCHLUMBERGER	-32
39	CORESTATES FINANCIAL	7	49	ALLSTATE	-14	19	MERRILL LYNCH	-33
12	PFIZER	5	6	MBNA	-21	43	HALLIBURTON	-34
48	RITE AID	5	14	US AIRWAYS GROUP	-22	31	NORTHERN TELECOM	-35
15	MERCK	2	27	COUNTRYWIDE CREDIT INDS.	-22	16	TRAVELERS GROUP	-35
23	HBO & CO.	1	35	STATE STREET	-23	7	TELLABS	-36
21	TJX	-1	40	NORWEST	-23	25	CONSECO	-36
32	CHARLES SCHWAB	-2	13	APPLIED MATERIALS	-26	38	GILLETTE	-39
42	FANNIE MAE	-4	46	HEALTHSOUTH	-27	26	MGIC INVESTMENT	-41
41	GENERAL ELECTRIC	-5	50	BANK OF AMERICA††	-28	9	COMPUTER ASSOCIATES INTL.	-41
45	FREDDIE MAC	-6	10	MORGAN STANLEY DEAN WITTER	-28	36	LEHMAN BROTHERS HLDGS.	-54
22	BRISTOL-MYERS SQUIBB	-6	24	CHASE MANHATTAN	-30	37	PARAMETRIC TECH.	-69

†† NationsBank merged with First Union in April. The price increase shown is based on the April 27 closing price. ‡ NationsBank merged with and changed its name to Bank of America on 10/1.



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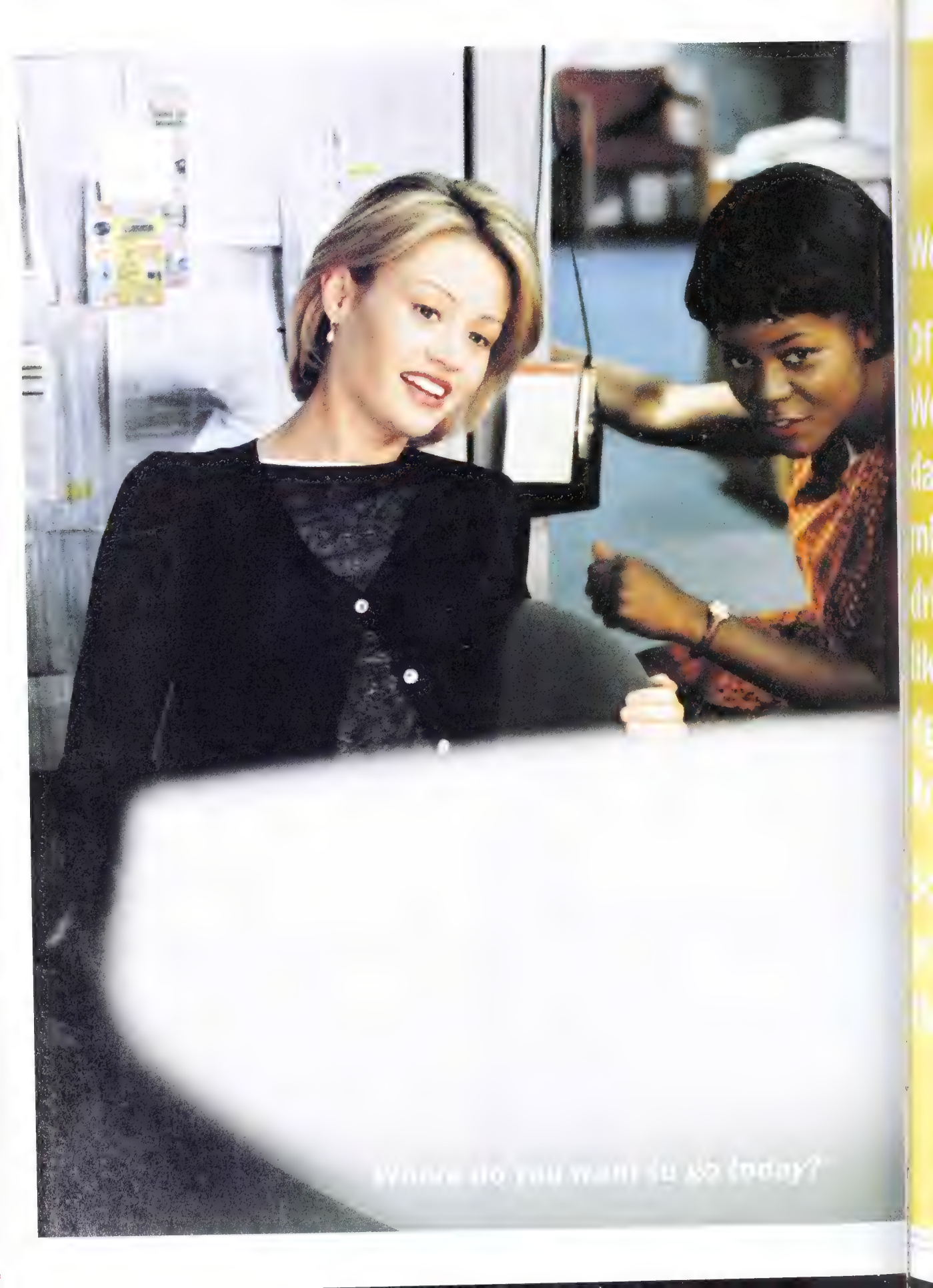
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SPIN-OFFS

WITH ALL THIS FIZZ, WHO NEEDS PEPSI?

Tricon is spicing up results at its fast-food units

Kazoos buzz and cowbells clang, shattering a Friday morning calm in the executive offices at Tricon Global Restaurants Inc.'s headquarters in Louisville, Ky. Casually dressed employees laugh and shout as they join in the so-called Roving Recognition Band snaking down the corridor to the office of John Henderson, a benefits analyst singled out for his good work on a budget report. Henderson waves thanks as workers clap plastic noisemakers.

Silly? Sure. But the band is just one of the gimmicks Tricon Chairman and Chief Executive Andrall E. Pearson and President and Vice-Chairman David C. Novak are using to rev up their 750,000 troops in the year since the fast-food operation was spun off from PepsiCo Inc. Novak regularly hands out rubber chickens to top-performing workers at the Kentucky Fried Chicken Corp. chain. At Pizza Hut Inc., they get big chunks of fake cheese. And at Taco Bell Corp., it's a giant papier-mâché chili pepper.

Pearson and Novak insist that the improved morale created by such rah-rah antics is key to maintaining momentum at the three chains. So far, they have executed some predictable first steps: wringing cost savings from combined operations, closing underperforming restaurants, and selling many company-owned units to franchisees. But now comes the hard part. To keep growth up, they need to show the chains can replicate this year's strong product launches and catchy marketing—such as



the wildly popular talking Chihuahua that pushes Taco Bell's Gordita soft taco. "You would think," Novak says, "that with Pizza Hut, Taco Bell, and KFC, we ought to be able to create a company at least the size of McDonald's."

¡No Quiero Taco Bell!



He's not there yet—Tricon's 1997 company revenues of \$9.7 billion don't match the burger chain's \$11.4 billion. But after a bumpy start, Tricon has picked up speed. For the third quarter, all three chains should show per-restaurant sales gains for the first time in five years. Peter Oakes, an analyst for Merrill Lynch & Co., estimates Tricon will finish the year with operating income of \$962 million, an 18.5% jump from 1997.

Not bad in an industry that usually measures its gains in the low single digits. And that's only the start of the good

PEARSON AND NOVAK:

Outlets boast the best numbers in five years

news. Profit margins are also up, thanks to the pairing of 585 unprofitable stores and the expected refranchising of 1,300 others by yearend. That has helped Tricon generate the cash needed to pay down about \$1 billion of the nearly \$5 billion debt PepsiCo stuck it with. Wall Street is clearly impressed. The stock is up 16% since its Oct. 7, 1997, initial offering, compared with 1% for the Standard & Poor 500-stock index. "We think well of their management," says Jeffrey J. Moran, an analyst at Pittsburgh-based Federated Investors, which holds 2.2 million shares. "When they were under PepsiCo, they were an afterthought."

Indeed, Novak and Pearson—both longtime PepsiCo executives—are still unsnarling some of PepsiCo's mistakes. The brands sometimes competed in ways that didn't make sense. KFC and Pizza Hut, for example, knocked heads in bidding for the same sites, driving up land prices. Today, Tricon coordinates those and other operations. By centralizing some food purchasing and packaging, the company estimates it will save \$10 million a year. And consolidating media purchases under a division of Young & Rubicam gave it more advertising clout. "I think under PepsiCo, the division president said, 'This is my business,'" Pearson says. "In Tricon, I think the notion is, 'This is our business.'"

Selling company-owned stores back to franchisees reverses another ill-fated PepsiCo legacy—one that started under Pearson when he was president of PepsiCo.

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from 1970 to 1985. The soda giant realized it could make more money on operating margins than on franchise fees, so it went on a buying spree in the late 1980s and early 1990s. It wound up owning more than half of its restaurants—more than four times the level of McDonald's. But management couldn't keep margins up, and margins sank. Novak now says he wants to push company-owned units down to about 20% of the total.

The more delicate task is repairing relations with franchisees. Many felt that PepsiCo execs didn't listen to their concerns. "PepsiCo's mentality," says Ken-J. Wagon, a Pizza Hut franchisee in Wichita, "was to treat franchisees as children: Just shut up and do as we told." But Novak, 45, has a reputation as a healer. Shortly after PepsiCo put him in charge of KFC in 1994,

he resolved an eight-year legal battle with franchisees. His relations with franchisees became even more critical as it came to the end of the franchise era for a large portion of over-100 franchises. Novak also needed to back up the franchisees to push through nationwide initiatives as a more rigorous system for rating restaurant cleanliness, service, and product quality.

SEASONING. At KFC, Novak also used his skills as a motivator. When he arrived, the chicken chain hadn't generated any sales growth in six years. So he went to the field to find out why. He surveyed 2,000 restaurant managers and got the same responses: Get us involved and help us retain work. Novak listened. He improved the quality by marinating before frying and gave workers goal-setting books. The payoff came as KFC's same-store growth leaped from 2% in 1994 to 7% the next year. "At the end of the day, our success is determined by how we treat our employees and our customer," says Barry Flax, co-founder of California Kitchen, which was itself sold by PepsiCo last year. "It is different from a bag of Fritos or a bottle of David gets it."

When it became clear that a spin-off of fast-food chains was imminent in early 1995, Novak seemed a logical choice to lead it. But PepsiCo CEO Roger Enrietto wanted a seasoned chairman to as-

sist him. Novak recruited Pearson, 72, who had left PepsiCo to become a Harvard business school professor and an investment banker. Pearson says he thinks of Novak "as a younger brother" and stays at his Louisville home when visiting from Connecticut.

The duo wants Tricon managers to bond in a similar way. It helps that they have extended up to \$20,000 in stock options—known as "Yumbucks," after the company's YUM stock symbol—down to the restaurant manager level. And they have put together a system in which ideas can be shared. During the Mexican peso meltdown of 1994-95, for example, Pizza Hut managers in Mexico noticed that customers could no longer afford regular-size pizzas. So they came up with smaller and cheaper

"Pizza Mia" pies. Last year, Tricon airlifted those specialists to crisis-racked Asia to help introduce smaller products there, too.

But the real test will come in Tricon's ability to pump out new products.

Long term, Novak says that he wants same-store growth rates of about 4%, compared with about 2% at Wendy's and Burger King and 4% at McDonald's, according to Merrill Lynch. That can only be achieved by keeping customers coming in for new treats. So far this year, Pizza Hut has registered big gains with its Sicilian and Edge pizzas, and KFC with its Popcorn chicken. Curiously, although Taco Bell's Chihuahua exploded into a licensing icon, Novak and Pearson were disappointed in the lift it gave Gorditas. They say the spots didn't say enough about the tacos. Future spots will show more product, less pooch. Also in the works is a new chicken sandwich for KFC.

Can they keep it up? While rival chains have taken note of Tricon's progress, they aren't ready to judge it a total success. "They could do more to address their core business," says Barry Schwartz, Burger King's director of brand research and analysis. For now, though, many Tricon franchisees appear happy with the progress made. This is one case where a little freedom, some stock options, and a rubber chicken can go a long way.

By Peter Galuszka in Louisville, with Kathleen Morris in Los Angeles



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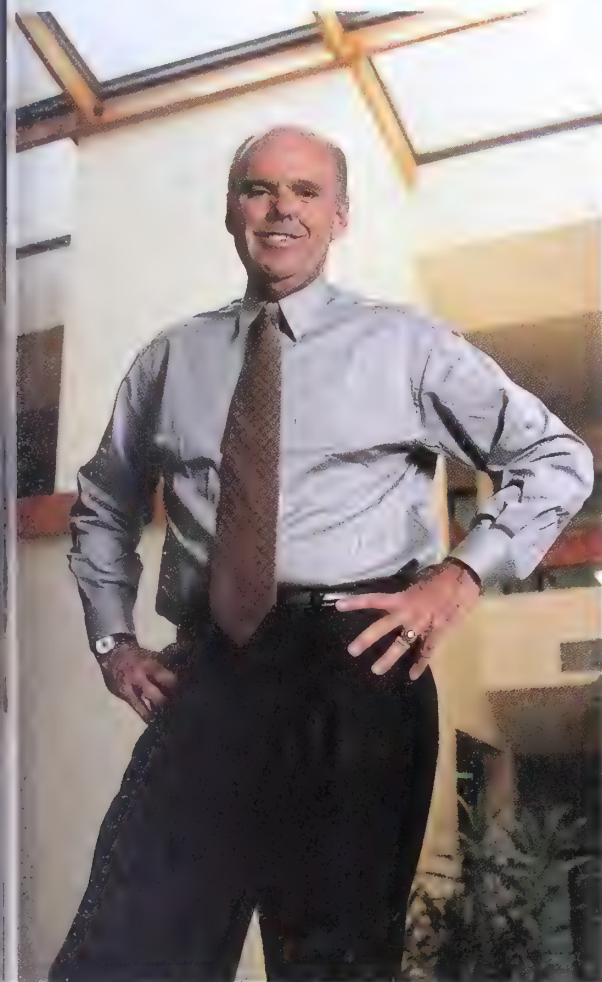


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EIGHT WINGS AND A PRAYER

ike Conway plans an airline with four planes and a vision



REET FIGHTER: Conway got bruised at America West

■ or Michael J. Conway, the 53-year-old founder of startup National Airlines, nothing has ever come easily. The son of a New York taxi driver, Conway grew up in a tough Brooklyn neighborhood where winning a street fight counted more than doing well in school. Years later, as airline executive, he has endured more than his share of professional check eyes. But Conway always seems to get up swinging. Now, five years after his ouster from

America West Airlines Inc. in a bitter power struggle, Conway is resurfacing with an ambitious plan for Las Vegas-based National, scheduled to begin flying early next year. He intends to start with a fleet of four Boeing 757 jets, flying to such cities as Miami, Los Angeles, and New York. It's a risky venture, though. As a tourist destination, Las Vegas fares run 30% below average domestic rates. And Conway will be competing against major carriers that have the muscle to squash new entrants.

PERSISTENT. Still, Conway knows the hazards of the market well. During his 12 years at America West, he helped build Las Vegas into one of two hubs for the Phoenix-based carrier, which was then expanding quickly. Later, he had to all but abandon the Las Vegas market after

America West's 1991 bankruptcy.

This time, Conway insists he's back to stay. And some big casinos, worried about luring new tourists, are also placing their bets with him. A construction boom is adding some 20,000 new hotel rooms to the market at the same time that major airlines are raising prices and cutting back flights in favor of more lucrative routes elsewhere. That's helped Conway raise \$50 million—\$30 million from Harrah's Entertainment Inc. and Rio Hotel & Casino Inc. Wexford Capi-



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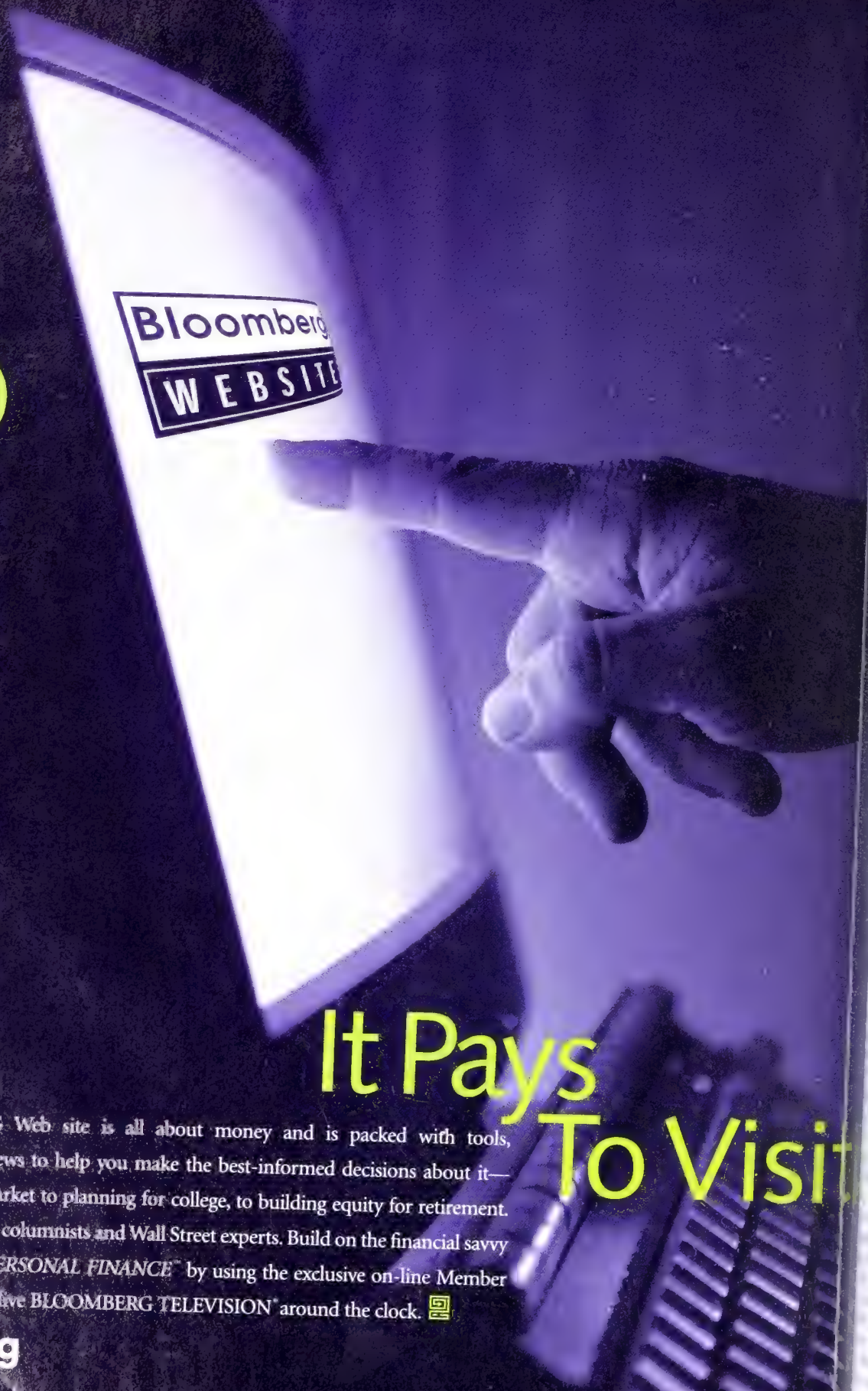
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1, a Greenwich (Conn.) investment firm, put in another \$7 million, with the rest coming from private investors. Finding the money, though, was no small feat. Conway set up shop in 1995 and began pounding the Strip for investors. But casinos weren't biting, telling Conway that airline seats always tend to grow in tandem with growth in hotel rooms. Conway, though, wouldn't take no for an answer. After such carriers as American Airlines Inc. and Delta Air Lines Inc. scaled back, the casinos came around.

Persistence, if not subtlety, has always been Conway's strong suit. The eldest of three kids, Conway grew up in a cramped house on a noisy street. His

father was more likely to discipline him with a belt than offer encouragement, says his sister, Kathy Geiger. At 17, Conway got into Queensborough Community College. But his five-year grade and a D combined for a grade-point average of 0.18. "My mother said, 'At least you could have gotten one full point,'" Conway recalls.

JTAL BATTLES. After working in the mail room at a local construction company, Conway went back to college, graduating from Baruch College in New York in 1969 with a degree in accounting and finance. This is how he did well and

got a job with Price Waterhouse, where he worked on the Eastern Airlines account. "It's fast-paced," says Conway, claiming his gusto for the airline industry. "It's capital- and labor-intensive, but it's also a service industry. It's a little bit of everything," he says. And brutal, too. After leaving the accounting firm to join Continental Airlines Inc. as controller in 1980, Conway crossed ways with Frank Lorenzo by losing the takeover race's bid for the line. He soon lost his job. In 1981, Conway joined then-tiny America West, which quickly rose to president. Over the next dozen years, he and founder Edward R. Beauvais built the airline into a billion-dollar carrier, with flights from its Phoenix and Las Vegas hubs stretching from New York to Japan.

But as the carrier grew, the pair clashed. Beauvais backed aggressive expansion. But during the Gulf War recession, Conway sided with creditors, who wanted the airline, by then bleeding red ink, to cut its costs. When the carrier declared bankruptcy in 1991, Conway and Beauvais became bitter enemies. Insiders say Beauvais felt Conway betrayed him, though Conway insists he fought the creditors on Beauvais' behalf. Beauvais, now retired, won't publicly comment on the rift except to say of his old partner: "I don't have a very high regard for him as a businessman."

With Beauvais out and Conway the new CEO, his real troubles were just beginning. Conway now had to deal

with William A. Franke, appointed by creditors as a nonexecutive chairman. Franke, an austere and formal Arizona investment banker who made his name turning around retail chain Circle K Co., took an immediate dislike to Conway and his backslapping ways, according to several company insiders. "Once Franke was in, he was de facto running the company and emasculating Mike," says a former adviser. Franke declined to comment for this story.

Conway plotted to rid himself of Franke in 1993 by courting a \$250 mil-

lion takeover from investor Michael Steinhardt. With the airline making money again, Conway counted on backing from the board. But he miscalculated badly. A competing bid from Texas financier David Bonderman, favored by Franke, won. Once again, Conway was out. "He's got a fine mind," says lawyer Penn Ayers Butler, a former member of the creditors committee. "It's just that when his emotions overtake his reason, Mike loses his ability to be a dispassionate judge of circumstances."

Will Conway's third time prove the charm? Though the risks are high, Conway is nothing if not a fighter. And this time around—for better or for worse—he's on his own.

By Steven V. Brull in Las Vegas

PILOT'S LOG

BORN 1945, Brooklyn

EDUCATION BA, 1969, Baruch College, City University of New York

FIRST JOB Working in the mail room of a construction company

WHY HE WENT BACK TO SCHOOL "The people making money were not in the mail room"

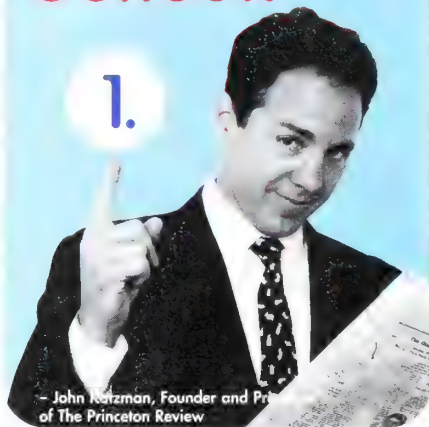
MOST SATISFYING ACHIEVEMENT Returning America West Airlines to profitability after its 1991 bankruptcy

WORST CAREER MOMENT When he was forced out of America West in 1993

FAMILY Married, three children

HOBBIES Golf; restoring old cars, including a 1963 Corvette

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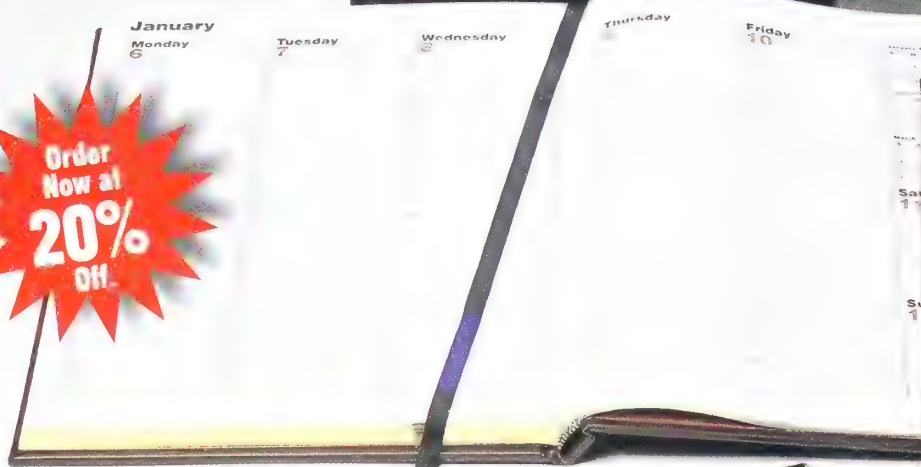
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WILL IT BE 'TIMBER!' OR GREEN LOGS?

Ecologically certified wood may run afoul of free-trade laws

As president of States Industries Inc., a Eugene (Ore.)-based company with annual sales of \$90 million in hardwood panels and plywood, Diane Montoya didn't worry much about the environmental impact of her purchases—until her children expressed their concern.

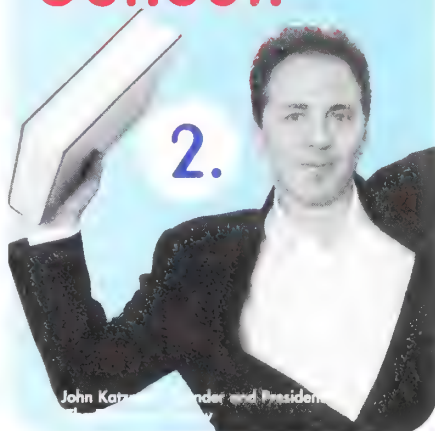
In August, Montoya joined the Certified Forest Products Council, an organization that promotes the purchase of timber harvested in an environmentally sound way—that is, timber that is cut selectively to allow sustainable, long-term harvests. Montoya has shifted some of her purchases to certified wood, easing her children's anxieties. Such voluntary efforts are leading to a growing market for certified wood. The problem, however, is that efforts by governments to require purchases of certified wood could, according to the World Trade Organization, be construed as barriers to free trade. Some environmentalists are concerned

that international trade agreements could threaten national sovereignty, interfering with consumers' right to make environmentally friendly choices—such as buying certified wood. The U.S. got a sample of the WTO's environmental clout in the spring, when the U.S. tried to block imports of shrimp unless they were caught in nets designed to protect endangered sea turtles. The WTO said the U.S. must allow the imports.

POOR SCIENCE? The conflict is likely to arise again with timber certification. So far, trade in certified timber is small. There are just 25 million acres of certified forests worldwide, and "green" forest products represent less than 1% of the total market. But large suppliers are getting involved. Three major producers—MacMillan Bloedel, Interfor, and Western Forest Products, all in British Columbia and all criticized for clear-cutting old-growth forests—recently said they intended to seek certification.

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nal Wood Products Assn., whose members are responsible for about 80% U.S. tropical hardwood imports, says the supply of certified wood is limited and too expensive to merit serious industry attention. But Sandy Mendler, architect in the Washington office of K&S, one of the country's largest architectural firms, disagrees: "The supply is much better than it was a few years

ago," she says. "I have very little sympathy for people who say it is too difficult." Pease's other criticism is harder to dismiss: She says timber certification is based on poor science—that researchers do not agree on how to manage forests to assure sustainable harvests. Indeed, in one study, A. Bowles and Richard E. Rice of Washington-based environmental group Preservation International determined that sustainable logging in an old-growth forest was very lucrative and did not protect

many species. They say the same may be true for other tropical forests. (The back timber certification in some separate regions where sustainable forestry seems likely to succeed.) The larger issue, however, is whether certification poses a barrier to trade. According to the WTO's Agreement on Technical Barriers to Trade, countries cannot discriminate against "like" products based on how they were produced. In other words, because a mahogany two-by-four from a well-managed forest looks like a mahogany two-by-four from a clear-cut forest, the two

are the same in the eyes of trade law.

"What the trade system has done is draw a very broad line in the wrong place. In many cases, these products are not the same," says Matthew Stilwell, an attorney with the Center for International Environmental Law in Washington. "We need a much more nuanced approach." Some other lawyers say they believe certification doesn't pose a barrier to trade because labeling is voluntary and standards are developed in an open process.

As timber certification gains momentum, it is eliciting more industry opposition. For instance, when the New York City Council, the Los Angeles City Council, and the California State Senate recently considered bills requiring government purchase of certified wood, they were all warned—by Pease's group or by the Canadian Consulate—of a possible trade violation.

In the absence of a formal dispute, the WTO is reviewing the regulations, says Doaa Abdel-Montaal of the WTO's trade and environment division. Whatever the WTO ultimately decides, timber certification alone will not save the world's forests. Only 22% of the world's forests remain intact and in large tracts, according to the World Resources Institute. And the current global economic crisis is putting increasing pressure on cash-starved developing countries to sell their trees. When they look at forests, they see glimmers of another kind of green.

By Marguerite Holloway in New York



NEW CONVERT: Montoya's company now buys certified wood

FREE TRADE VS. ENVIRONMENT

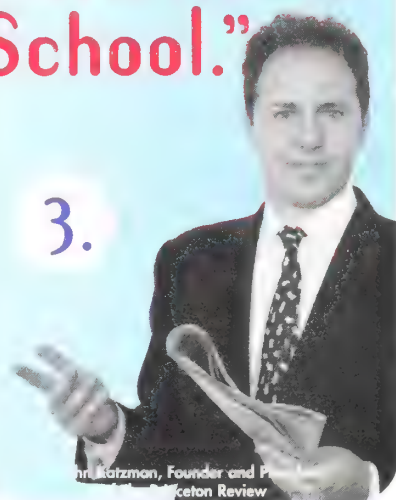
Free-trade agreements are threatening to undermine U.S. efforts to safeguard the environment. The issue is: Does the U.S. have the right to restrict imports based on environmental concerns? So far, the answer seems to be no.

U.S. law prohibited the import of shrimp caught in nets that could trap and kill endangered sea turtles. Last spring, the WTO ruled that the U.S. must allow such imports.

Some U.S. companies are choosing to purchase wood harvested in an environmentally sound way. When Los Angeles, New York City, and California Senate considered bills to require such purchases, timber industry officials warned them that such bills could violate international agreements.

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3.



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A black and white photograph of a man with dark hair, smiling at the camera. He is wearing a dark, long-sleeved button-down shirt over a white t-shirt, and light-colored trousers. He is leaning on a dark-colored bicycle, with his hands on the handlebars. The background is plain white.

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Special Report

THE BEST B SCHOOLS

Wharton may be tops—again—but this year, every grad is golden

Quit while you're ahead. It's not the most complex principle you might learn in B-school, but it's the final lesson Thomas P. Gerrity, dean of the University of Pennsylvania's

Wharton School, is giving his students. After once again leading Wharton to the No. 1 spot in BUSINESS WEEK's ranking of the best B-schools—a spot it has held since 1994—he has decided it's time to turn over the reins. On Oct. 6, Gerrity, 57, announced plans to step down at the end of the current school term after nine years as dean in order to spend more time with his family. "I've seen too many people stay on too long," he says. "There's something about turnover which involves renewal and rebirth."

Of course, longevity has its advantages as well. The runner-up in our ranking, Northwestern University's J. L. Kellogg School of Management, is led by Donald P. Jacobs, who has been dean since 1975—not long after many members of the Class of 1998 were born. The 71-year-old Jacobs, whose school monopolized the top ranking from 1988-92, has no intentions of passing the baton. "Someone's gonna have to fire me," he jokes. "The reality is that I really enjoy this job." This year, Kellogg bounced back to No. 2 from No. 3 in 1996, thanks largely

to an improved ranking from grads who lauded its balance between academics and other activities. It unseated the University of Michigan, which suffered a two-place drop in its ranking from recruiters, and fell to fourth place overall.

Rounding out the top was this year's No. 3, the University of Chicago, which made a U-turn after its dramatic slip to No. 8 in 1996. Chicago's recovery came as it turned itself inside out to regain the support of its students and recruiters, who voted it most improved. It wasn't the only one to make a big leap. Cornell University's Johnson Graduate School of Management vaulted 10 spots, to No. 8, thanks to an new curriculum and an administration more inclusive of students.

Elsewhere, too, there was plenty of movement—as frequently down as up. Harvard's B-school fell a notch, to fifth, largely because student satisfaction slumped. One big problem: controversy over the administration's handling of an alleged sexual harassment incident between students. Stanford University fell two spots, to ninth, due in part to the ire of recruiters frustrated because students abandoned them for tiny Silicon Valley startups. The University of Virginia's Darden School—the leader in student satisfaction in 1996—plummeted from

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Examining BW's elite 25

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A tale of two surveys

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How BW dealt with fishy data

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A dispatch from the front lines

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Foreign students get short shrift

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Do GMAT cram courses help?

HELPING HANDS Page 180
Admissions advisers for hire

BusinessWeek ONLINE

For more, including all-new school profiles, in-depth statistics, and grads' comments, go to www.businessweek.com.

1 Wharton

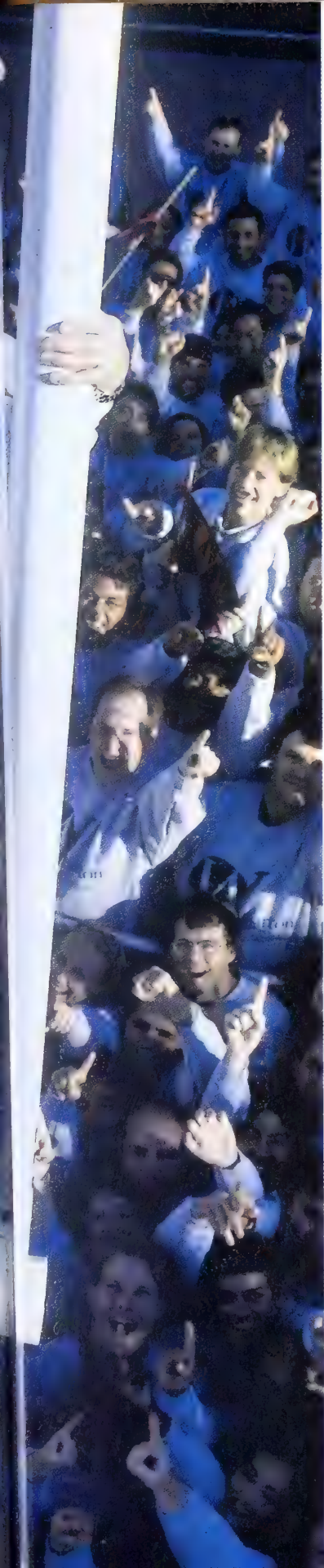
Thomas Gerrity guided his school to the top of our list for the third straight time in 1998. But Gerrity won't be Wharton's guiding light for long: The dean will retire after nine years to spend more time with his family

2 Kellogg

3 Chicago

4 Michigan

5 Harvard



No. 5 to No. 11 as the Class of 1998 complained about the workload and the ability of the placement office to prepare them for job interviews. And this time around, there were four new members of the top 25—the University of Maryland's Robert H. Smith B-School, the University of Wisconsin at Madison, Purdue

Unlike other rankings projects, BUSINESS WEEK takes the customer's point of view to rate the quality of business education. We believe the best results come from asking students and the companies that hire them to rate their experiences. So we sent extensive questionnaires to 9,598 graduating MBAs at 61 schools—our largest survey ever—as well as to 350 companies that actively recruit. We heard back from 6,020 students and 259 companies (page 92).

SAVIER STUDENTS. Graduates—who judge only their own schools—were asked to give their views on such issues as teaching quality, program content, and career placement. Recruiters were asked to assess the skills of the students and rank B-schools on their overall quality and the success rate of graduates in their organizations. Since startups or companies without experi-

ence recruiting at different schools aren't included in our survey, schools that are sending a higher percentage of students into entrepreneurial ventures could be affected. Both polls were combined to produce the list.

But whatever quibbles members of the Class of 1998 may have had individually, they didn't have a lot to complain about overall. Many members revealed that they were among the luckiest group of MBAs ever to come out of school. Indeed, a suddenly shaky economy has begun to worry those still on campus. "If the market tanks, will the hire one-third [as many] people?" wonders Cesar R. Conde, a second-year Wharton student. "I hope to God not."

For those who finished school in the spring of '98, an MBA from an elite B-school was a sizzling commodity—golden ticket into a world of six-figur-

Special Report

THE BEST B-SCHOOLS

University's Krannert School of Graduate Management, and the University of Southern California's Marshall B-school. Falling out of the top 25: the B-schools at Southern Methodist University, Vanderbilt University, Thunderbird (American Graduate School of International Management), and the University of Rochester.

A Report Card For the Top 25

It was a great time to get an MBA. Sure, you might have been able to take advantage of that now-disappearing bull market had you stayed in your cubicle. But if you went to any of the schools on this list, you got a great education—and hit payola, too.

With pay packages reaching record levels—the average median salary and bonus was \$91,560—students had the luxury of weighing several offers, most of which came with added perks that made the deals even sweeter.

The letter grades are based on graduate and recruiter surveys from the 61 schools we surveyed this year. Similar to the forced curves students might face at Harvard or Chicago, the top 20% in each category get As. The next 25% get Bs, the next 35% are awarded Cs, and the bottom 20% get Ds. See page 92 for more information on how we crunched the numbers.

1998 RANK	SCHOOL	1996 RANK	CORP. POLL	GRAD POLL	ANNUAL TUITION*	APPLICANTS ACCEPTED	WOMEN	ENROLLMENT INT'L MIN.
1.	PENNSYLVANIA (Wharton) Philadelphia	1	1	2	\$24,990	13%	29%	31%
2.	NORTHWESTERN (Kellogg) Evanston, Ill.	3	2	6	24,351	14	32	24
3.	CHICAGO Chicago	8	3	9	26,284	24	22	23
4.	MICHIGAN Ann Arbor	2	5	3	25,000	22	28	26
5.	HARVARD Boston	4	6	13	26,260	13	30	26
6.	COLUMBIA New York	6	4	21	26,180	12	37	26
7.	DUKE (Fuqua) Durham, N.C.	11	7	10	24,100	17	33	25
8.	CORNELL (Johnson) Ithaca, N.Y.	18	11	4	23,400	28	26	32
9.	STANFORD Stanford, Calif.	7	9	8	24,990	7	29	29
10.	DARTMOUTH (Tuck) Hanover, N.H.	10	13	7	24,900	12	28	19
11.	VIRGINIA (Darden) Charlottesville, Va.	5	8	15	20,429	15	30	21
12.	UCLA (Anderson) Los Angeles	12	18	1	20,093	14	28	24
13.	NYU (Stern) New York	14	10	20	25,884	18	38	34
14.	CARNEGIE MELLON Pittsburgh	17	15	5	24,000	30	24	39
15.	MIT (Sloan) Cambridge, Mass.	9	14	19	25,800	13	27	37
16.	UC BERKELEY (Haas) Berkeley	13	16	14	19,792	11	34	31
17.	WASHINGTON U (Olin) St. Louis	16	19	16	23,920	34	29	36
18.	TEXAS Austin	20	12	26	14,762	23	25	22
19.	UNC (Kenan-Flagler) Chapel Hill	19	23	17	16,091	24	27	21
20.	YALE New Haven	22	27	11	25,250	25	32	30
21.	INDIANA Bloomington	15	20	25	17,013	40	28	19
22.	MARYLAND (Smith) College Park, Md.	NA	30	23	14,090	21	36	39
23.	WISCONSIN Madison	NA	17	32	15,380	47	31	32
24.	PURDUE (Krannert) W. Lafayette, Ind.	NA	21	29	14,708	25	26	36
25.	USC (Marshall) Los Angeles	NA	55	18	22,638	26	30	25

*1998-99

** Post-MBA pay = Median salary, bonus, & other compensation

For the Class of 1998, an MBA from an elite school was a ticket into a world of six-figure salaries

aries and jobs with real responsibility. e booming economy and the need for experienced managers led recruiters in a survey to hire 10,348 MBAs, up 28% from 1996, the last time we conducted a survey. They would have hired even more if they could have. Grads in our survey averaged 3.2 job offers. Competitive salaries soaring: The median package (salary, bonus, and extras such as stock options or moving expenses) at the top 25 hit \$111,420, up 12% from 1996. Another telling figure: The median pay topped \$100,000 at 18 of the top 25—vs. 5 two years ago.

son for those salaries. Today's B-schoolers have more work experience—an average of 3.9 years for this fall's incoming class—so recruiters expect them to contribute from Day One. "You have a much savvier individual, with more maturity and more experience" than a few years ago, says Maury Hanigan, CEO of Hanigan Consulting Group in New York, which helps companies recruit MBAs.

Just as important, students are better prepared for the real world. As competition has stiffened, schools have become far more responsive to students' needs. Students report that schools often turn on a dime to upgrade facilities or re-

move poor teachers and that they are now included in such decisions as a dean search or curriculum change. And thanks to student demands, almost every B-school has devoted more resources to classes on technology and entrepreneurship. A few examples: Massachusetts Institute of Technology's Entrepreneurship center, launched in 1996, now houses the fastest-growing track at the Sloan B-school—new-product and venture development. And at the University of California at Berkeley's Haas B-school, one of the hottest electives is a "Trends in Technology" course.

Add it all up, and it's hardly surpris-

AN PAY ** POST-MBA	GRADS EARNING OVER \$100,000	AVERAGE JOB OFFERS		MBA SKILLS GRADED BY RECRUITERS			SCHOOLS GRADED BY MBAS		
				ANALYSTS	TEAM PLAYERS	GLOBAL VIEW	TEACHING	CURRICULUM	PLACEMENT
\$125,500	83%	3.2	Holds on to commanding lead with recruiters, as dean announces plans to step down. Students give it all-around high marks.	A	A	A	B	B	A
125,000	72	3.4	Grads and recruiters say it's tops in teamwork. Recruiters love marketing skills. Will start building a new addition to B-school next year.	A	A	A	B	A	A
120,000	80	3.4	Impressive rebound as students say teachers tops in their fields, offers freshest material. Recruiters vote it most improved, best in finance, analytics.	A	A	A	A	A	A
115,000	67	3.5	Slips two spots in recruiter survey, still most innovative, best in operations. Partnering with Catalyst for study on why so few women in B-school.	A	A	A	B	B	A
145,000	86	4.0	Students laud connections, recruiters say best in management and communications. Despite tech push, students gave lowest scores on their ability to deal with computers.	A	A	A	B	B	B
125,000	76	3.0	Students complain about facilities, unavailable teachers, but recruiters hike it two spots. New building set to open shortly.	A	A	A	C	B	A
109,000	50	3.2	Jumps three spots in recruiter poll and four overall as strategy of developing ties with key companies pays off. Oldest grads (average age: 29.2).	A	A	A	C	B	A
115,000	64	3.3	Dramatic rise after dramatic fall in '96. Students give it top scores for meeting expectations, responsiveness of profs and staff. New building just opened.	A	A	A	A	A	A
138,000	74	3.6	Students give lowest rank in core teaching, course integration, responsiveness, but laud analytics, interpersonal skills as the best. Recruiters frustrated.	A	A	A	C	A	A
127,000	83	2.7	Gets top votes for making tech part of learning environment. Most available faculty out of the classroom, most loyal alums.	B	A	B	A	A	B
115,000	64	2.9	Student dissatisfaction with job placement, overwhelming workload drops school six spots. Yet students also say it's best in ethics and in integrating coursework.	B	A	A	A	B	C
115,000	57	2.7	Ranked No. 1 in entrepreneurship, summer job placement, best use of technology in the classroom. In midst of lengthy dean search.	B	B	B	B	B	A
120,000	62	2.7	Students are happier, yet recruiters drop school one place after voting it most improved in 1996. Soon-to-be expanded facilities should ease congestion.	B	B	B	B	B	A
109,000	55	3.7	School gets top rank from students for info tech as it tries to escape quant stereotype. All students get alumni mentors. Recruiters say it's No. 2 in tech, operations.	A	B	B	B	C	B
130,000	74	3.7	Recruiters drop school six spots, yet still say it's best in tech. Students give highest marks for diversity, but say profs most likely to compromise teaching for research.	A	B	A	C	C	B
117,000	54	2.5	Students rate school lowest in number and quality of firms on campus. Fewest average job offers per student. New dean is only woman in top 25.	B	B	B	B	B	B
89,000	19	3.4	New curriculum and grading system please students, who praise intimate environment. Moves up one spot in recruiter poll.	B	B	B	A	B	B
97,000	39	3.1	School moves up thanks to three-spot gain in recruiter survey. Technology initiatives include world's largest Windows NT lab, trading and tech center.	B	B	B	C	B	B
107,000	52	2.9	New dean, new building fuel push to boost technology. Working on developing niches in environment and economic development.	B	B	B	A	A	B
116,000	54	3.1	Move towards a more traditional MBA paying off some with recruiters. Students score it lowest in info tech but much higher overall than 1996.	B	B	B	A	A	A
92,000	31	2.9	School continues slide, gets worst elective teaching score for second straight time. Falls seven spots in recruiter survey, six overall.	A	A	B	A	B	C
84,500	28	3.2	High student and improved recruiter marks push school into the top 25. Youngest students (average age, 27.6). Students give lowest marks for contact with professionals.	C	C	C	B	B	B
70,000	11	3.0	Student satisfaction up, but students least likely to urge friends to take the same program. Students have lowest pre- and post-MBA pay in top 25.	C	C	C	C	C	B
86,500	23	4.2	School bounces back into top 25 after dean gets students involved. Recruiters praise its operations grads. Most job offers per student.	B	B	B	C	D	B
93,000	31	3.0	Top marks in international business from grads, thanks in part to popular PRIME study program. Recruiters give dismal grades for finance, analytics.	D	C	C	A	A	A



ing that applications hit an all-time high of 89,031 for the current class—up 10% from just two years ago, thanks largely to a surge in international applications. Given the economy's troubles, some worry that the numbers of foreign students may drop, as the relative cost of U.S. B-school increases. Yet B-school can be countercyclical, drawing those who would like to sit out a sour job market, so domestic applications could rise.

No matter which way things go, it's a

made recently at Wharton and cited by the Class of '98 were two new majors—one in technological innovation and another called ITSE (information systems, technology, strategy, and economics). Students also liked e-Talk, an electronic chat group created for admitted students this year that resulted in the formation of friendships, living arrangements, and even a rock band before anyone hit campus. Other changes included a fourth upgrade of the school's intranet, an interactive online alumni directory that will go live this fall, and a course-bidding system that allows students to signal which classes are their top priority. It also helps the school allocate resources more efficiently.

None of these achievements was seen as particularly revolutionary. At Wharton, they're normal improvements expected to outlive their usefulness. "We were always meeting with different people" in both the faculty and the administration, says recent grad Kavita R. Shah, "so there was constant feedback and cross-checks." Recruiters were plenty satisfied, too, citing a unique combination of breadth

A SCHOOL THAT WORKS

Chicago's Hamada added a concierge desk to assist recruiters

and depth. "You get the most for your dollar with a Wharton student," says Paula Goodman, vice president and senior recruiter at Citibank. "They're just specialized enough but just general enough."

there are extenuating circumstances the Wharton student is best able to just go with the flow."

While not all schools share Wharton's track record, a few took leaps forward after dropping in our rankings the last time around. The University of Chicago and Cornell's Johnson school were two that bounced back. After student dissatisfaction sent Chicago tumbling five spots in 1996, the school went through a serious bout of navel-gazing. The result: Virtually everything but the faculty, which remains a key strength, got a wholesale makeover. "I think it's fair to say that we just swept out the old," says Dean Robert S. Hamada.

TEAMWORK. To improve communication, Hamada created a deputy dean position to focus on the needs of full-time students. A cash prize now goes to the most effective member of the administrative staff—voted on by students. Hamada also added a bit more emphasis on communications and teamwork to the core analytic skills for which Chicago is famous. Similar efforts went into gaining favor with recruiters, who slammed the placement office in 1996. Hamada brought in a new staff and

added such amenities as valet parking and a concierge desk. He also set up an "account manager" system, in which staffers work with specific industries to ensure that recruiters get the assistance they need.

The efforts paid off. Recruiters voted students most improved, and students raved about Chicago's ability to keep academics first and still open to students. "The administration was tremendously flexible and responsive to student needs," says '98 grad Lori Brazil Gery. "Everyone was really interested in teaching. There are a lot of young professors that made a great impression on the student

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THE BEST B-SCHOOLS

good bet that plenty of applications will land on the desk of Robert J. Alig, director of admissions and financial aid at Wharton. This year alone, applications for the school's 765 spaces rose 14%, to a record 8,313. It has been a crazy whirlwind for Alig: His office conducted 6,000 interviews last year and some 1,000 "why deny" meetings, in which rejected students get feedback on what they need to do to try again.

FINE-TUNING. That frenzy is in large part a result of the culture created by Gerrity. Wharton is a place where continuous improvement is a reality rather than an empty phrase reeking of consultant-speak. While recent moves haven't been nearly as radical as the curriculum overhaul of the early 1990s, an endless fine-tuning keeps students and faculty excited. "What has clearly emerged is a healthy, organic process that's growing in strength," says Gerrity.

Among the small but integral changes

The Up-and-Comers

Schools that are coming on strong

PROGRAMS SHOWING GREATEST IMPROVEMENT

- | | |
|-------------|-------------|
| 1. CHICAGO | 4. DUKE |
| 2. MICHIGAN | 5. COLUMBIA |
| 3. KELLOGG | |

SCHOOLS WITH MOST INNOVATIVE CURRICULA

- | | |
|-------------|------------|
| 1. MICHIGAN | 4. HARVARD |
| 2. WHARTON | 5. CHICAGO |
| 3. KELLOGG | |

PROGRAMS SHOWING GREATEST RISE IN NEW SATISFACTION

- | | |
|--------------|---------|
| 1. CHICAGO | 4. USC |
| 2. CORNELL | 5. YALE |
| 3. WISCONSIN | |

DATA: BW SURVEYS OF RECRUITERS AND GRADUATES



ilarly broad changes took place Cornell, which has undergone a re-under Dean Robert J. Swieringa, came on in 1997. Students gave marks to a revamped core curriculum designed together with faculty. It also added marketing and computing versions of the school's "immersion" manufacturing course, in which students can spend the second semester in first year on one class. "[The accreditation] came through for us with

everything," says recent grad W. Daniel Alvarez. Most remarkable was that big changes got made after less than a year. "We asked for more immersion courses, and they told us it would take two years. We said that wasn't good enough, so they did it faster."

It's a lesson that MIT's Sloan School of Management may soon have to learn. Poor marks from both students and recruiters have dropped the school from No. 9 to No. 15. Students felt that pro-

THE BUZZ IN L.A.

Students loved UCLA's friendly culture and its committed teachers

fessors hadn't integrated the curriculum very well and that the school was not very responsive in meeting the demand for electives. Some of the grumbling related to fewer corporate finance

choices in one semester, resulting in excess demand for the class taught by Jeremy C. Stein, one of the school's most popular faculty members. Students asked for more options, but the school wasn't able to solve the problem. "I can't clone him," sighs Interim Dean Richard L. Schmalensee, who has added more corporate finance courses.

Sloan didn't fare much better with recruiters, who continue to rave about Sloanies' technology skills but grew frustrated when many spurned them for more entrepreneurial jobs. That doesn't much faze Schmalensee: "If there's one thing you want to be unhappy about," he says, "it's when you hear 'I tried to hire your students and couldn't.'"

CAMARADERIE. Virginia's Darden School also came under fire. While students continued to laud the accessible faculty and the innovative curriculum that integrates core courses, the "boot camp" feel of the first year left many feeling exhausted and unprepared for their job interviews. "The first-year workload is too much," says one student, "and hurts those people needing to spend a significant amount of time in the job search process." Grads also complained about a placement office in transition. New Dean

Best and Worst Placement Offices

*Who's got the connections? Who's got the interview schedules?
Whose students keep getting dinged?*

THE BEST

- 1. UCLA**
Recruits as No. 1. Recruiters say it's best for students, No. 2.
- 2. MICHIGAN**
Recruiters give it the No. 2 slot, laud responsiveness.
- 3. HARVARD**
Though many recruiters dropped it, those that stayed are content.
- 4. DUKE**
Recruiters are happier than students, but they're not complaining either.
- 5. CORNELL**
Recruiters say it's the best. Aggressive efforts to bring in new recruiters pay.

THE WORST

- 1. UC-BERKELEY**
Students and recruiters agree: Office needs help.
- 2. MARYLAND**
Recruiters give it lowest placement scores.
- 3. WISCONSIN**
Students say it's weak on professional contacts.
- 4. VIRGINIA**
No placement office gets lower marks from grads.
- 5. INDIANA**
Students very frustrated, but recruiters give it decent scores.

Rankings are based on a statistical compilation of student and recruiter surveys from the top 25 schools.

DATA BUSINESS WEEK

Edward A. Snyder acknowledged that the course load is demanding but says it better prepares students for real life. The school has added a unit on career development to the orientation process.

Happier students were to be found across the country at the University of California at Los Angeles' John E. An-

Special Report

THE BEST B-SCHOOLS

derson Graduate School of Management. The school got the best overall scores from graduates in the poll. Despite being located in a huge metropolitan area with plenty of distractions, the camaraderie and committed teachers left students feeling that they had gotten a lot more than a piece of paper when they left. "This is a small community within a sprawling one," says Dominique Litmaath River, a recent grad. "By Thursday [of each week], everyone always had 20 E-mails from [others] sailing at

Favorite Hunting Grounds

Where companies say they find the best graduates for specific skills

GENERAL MGMT.	MARKETING	FINANCE	TECHNOLOGY
1. HARVARD	1. KELLOGG	1. CHICAGO	1. MIT
2. KELLOGG	2. HARVARD	2. WHARTON	2. CARNEGIE MELLON
3. MICHIGAN	3. MICHIGAN	3. HARVARD	3. MICHIGAN
4. WHARTON	4. WHARTON	4. COLUMBIA	4. WHARTON
5. CHICAGO	5. DUKE	5. MICHIGAN	5. CHICAGO
6. STANFORD	6. CHICAGO	6. KELLOGG	6. STANFORD
7. VIRGINIA	7. STANFORD	7. NYU	7. KELLOGG
8. DUKE	8. COLUMBIA	8. INDIANA	8. HARVARD
9. COLUMBIA	9. CORNELL	9. DUKE	9. DUKE
10. DARTMOUTH	10. UCLA	10. STANFORD	10. PURDUE

DATA: BUSINESS WEEK

the marina, going to the movies, or hiking." The students shared both good times and stressful ones. "People were totally unselfish," says Spencer Cutter, a '98 grad. "They E-mailed their notes to the whole class. If 10 people wanted a

job at J.P. Morgan and they were hiring two, they would share information. Happy campers, the MBAs of 1998. Here's hoping that the real world treats them as well as B-school did.

By Jennifer Reingold in New York

CRUNCHING THE NUMBERS: A TALE OF TWO SURVEYS

Let the customer speak. That's the philosophy behind BUSINESS WEEK's ranking of the best business schools. We think B-schools have two customers: the graduates, who trade their suits for backpacks; and recruiters, who seek out the best and brightest from among the business schools' ranks. The frank views we receive from both groups have made BUSINESS WEEK's ranking a crucial source of information on business schools since it was first undertaken a decade ago.

We asked for feedback from graduates of the Class of 1998 at 61 top schools—10 more than in 1996. On the recruiter side, 259 companies who hired a total of 10,348 new MBAs this year gave us their input. We enlisted two esteemed statistics consultants, David M. Rindskopf and Alan L. Gross, professors of educational psychology at the City University of New York Graduate School & Uni-

versity Center, to analyze the data and ensure that it met our quality standards.

GRADUATE SURVEY: We sent a 39-question survey to 9,598 randomly selected members of the Class of 1998. We got back 6,020 replies, for a

response rate of 63%. For the first time, we let grads complete the survey either online or on paper, and two-thirds of the respondents took the digital option. Grads were asked to answer most questions on a scale of 1 to 10. One example: "How would you judge the responsiveness of the faculty and administration to students' concerns and opinions?" In this case, an answer of 1 meant poor, while 10 stood for outstanding.

The 1998 surveys count for 50% of a school's student-satisfaction score. The other 50% comes from the responses of 4,891 graduates in the 1996 poll and 4,626 from 1994. Each carries a weight of 25%. This is done

to ensure that short-lived changes don't have too much impact. We also removed any surveys that our consultants found to be statistically aberrant (page 94).

RECRUITER SURVEY: A total of 350 companies that are active recruiters of MBAs were polled, and 259, or 74%, responded. Recruiters were asked to rank their top 20 schools in order, based on the quality of the students and their company's experience with the graduates. The top school got 20 points, and No. 20 got one point. Each school's total score was then divided by the number of responding companies that recruited MBAs from that school. Because larger schools tend to attract more recruiters, we gave some of the smaller schools an upward adjustment to counter any possible bias.

COMPOSITE RANKING: To come up with its overall ranking, BUSINESS WEEK combines the raw scores of both surveys rather than totaling a school's rank in both polls and dividing it by two. This approach accounts for the statistical significance of one school's lead over another in each poll and gives more credit to schools with a commanding advantage in one area. Because there are greater differences among the schools in the corporate survey, recruiter opinion tends to have a slightly greater weight in the overall ranking.

The Survey

	GRADUATE POLL		
	1994	1996	1998
SURVEYS	6,353	7,235	9,598
REPLIES	4,626	4,891	6,020
RESPONSE RATE	74%	67%	63%
	RECRUITER POLL		
	1994	1996	1998
SURVEYS	354	326	350
REPLIES	254	227	259
RESPONSE RATE	72%	70%	74%

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HOW WE KEPT THE DATA UNSULLIED

When BUSINESS WEEK began its ranking of the best business schools back in 1988, the idea was to give a voice to those who paid thousands of dollars for their education, and the companies that hired them. Over time, the rankings have grown in importance—so much so that the day they are released resembles either a funeral or a wedding at some schools.

We're glad the rankings are taken so seriously. But this year, some people took them too seriously. After an investigation lasting several months, BW determined that some students at five schools tried to "game" the system by inflating their responses on the student portion of the BUSINESS WEEK survey. They urged their fellow classmates to answer the survey questions positively in hopes of moving up in the rankings. The five schools: Dartmouth, Duke, Purdue, the University of Texas at Austin, and Washington University.

There is no evidence that school administrations or faculty had anything to do with the students' attempts. The deans at four of those schools argue that if any discussion of the surveys did occur, it merely reflected the enthusiasm students feel about improvements at their schools. Says Ramesh K. S. Rao, director of the MBA program at Texas: "I hate to see [our students'] uniformity and beliefs about the direction we're going penalize us." Purdue's

dean, Dennis J. Weidenaar, says his own investigation uncovered no proof of any discussions or transgressions at all.

Nonetheless, we have strong evidence indicating that some of the graduate surveys at those schools were tainted. As a result, we adjusted the grads' scores at those schools, giving the 1998 data a weight smaller than its usual 25%. We increased the relative weighting of two previ-

ous student surveys from 1996 and 1994. We kept the weight of the recruiter survey intact at 50%.

The student efforts typically took the form of boosterism. At Washington, students distributed "mock surveys" with BUSINESS WEEK's logo, which showed how the rankings were calculated, and reminded students that the BUSINESS WEEK sur-

veys from 1996 and 1994. We kept the weight of the recruiter survey intact at 50%.

veys, as well as those of anyone we felt answered inaccurately.

CONFIDENCE. As a cross-check, we consulted with David K. Krane and Humphrey Taylor, executive vice-president and chairman, respectively, at

pollster Louis Harris & Associates Inc.

They helped us develop a new survey, asking respondents if they were aware of any attempts to influence the survey and whether, if so,

they felt that the efforts had succeeded. Applying all three methods, we concluded that some data from the five schools was suspect.

The BUSINESS WEEK survey process differs from other rankings that rely in large part on one source—material provided by the schools. Our rankings, by contrast, combine the views of thousands of people. With such a volume of data, we believe our results continue to offer the truest reflection of customer sentiment. And the checking procedures we've put in place give us more confidence than ever in our data.

BUSINESS WEEK will continue to do what it takes to maintain the integrity of the B-school surveys. If necessary, we will even remove schools from our rankings. We will also issue guidelines to students and schools to further clarify that the survey is meant to measure individuals' satisfaction level with their schools. It's an opportunity that MBA students didn't get just a few years ago.

By Jennifer Reingold, with Hala Habal, in New York

BusinessWeek 1998 B-SCHOOL SURVEY

Feedback is important to us. All feedback is strictly confidential. All your responses to the following questions are strictly confidential. For security reasons, your password will expire when you submit this survey.

PART 1 OF 3

Name of School

American Thunder
University of Arizona

Home Address

234 My Street
My City
My State
My Zip Code
My E-mail
My Phone

First Name

Last Name

Password

☐ Check box if y

First-year Sta
Salary

PART 2 OF 3

The following 52 questions are based on a numerical scale of 1 to 10. On most questions, though not all, you should click 1 if your satisfaction level was poor or 7 if it was excellent. A score of 10 would indicate an unusually outstanding level of performance.

1 To what extent did your MBA experience fulfill or fail to meet your expectations of what a good program should be?

Failed expectations 1 2 3 4 5 6 7 8 9 10 Fully met

2 Do you believe your MBA was worth its cost in time, tuition and lost earnings?

Return was 0% 1 2 3 4 5 6 7 8 9 10 100% Return

3 How would you rate the quality of the teaching in your MBA program?

1 2 3 4 5 6 7 8 9 10

Some students at five schools tried to skew the poll results

vey was not the right forum for criticism. At Texas, several student government leaders circulated a memo reminding students how important it was to keep the school competitive in the rankings. "Let's ensure that we place the University of Texas MBA program on a level playing field," it stated. And at Dartmouth, students told each other that the survey's 1-to-10 scale was irrelevant; they suggested giving the school "9's" if they hated the school, "10's" if they loved it.

To maintain the integrity of our data, we checked out every rumor or suggestion of misconduct we heard. We followed a three-step quality-control process. First, we called students, faculty, and deans to determine what happened. We learned about some events from students, who wrote saying they felt their school had been misrepresented. Next, we brought in

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dean, Dennis J. Weidenaar, says his own investigation uncovered no proof of any discussions or transgressions at all.

Nonetheless, we have strong evidence indicating that some of the graduate surveys at those schools were tainted. As a result, we adjusted the grads' scores at those schools, giving the 1998 data a weight smaller than its usual 25%. We increased the relative weighting of two previ-



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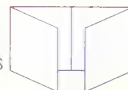
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Smart Companies



THE MBA ROAD

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to an elite B-school paid off
for the class of 1998.
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THE FOLLOWING PAGES



ROAD

at America's best B-schools
experience—with exclusive
1998 at our Top 25 schools
in us for the ride.



The Students

MINORITIES*

Most		Least
TEXAS,		YALE
N. CAROLINA,		CARNEGIE
MIT	14%	MELLON
MICHIGAN	13	CHICAGO

AVERAGE 9%

Does not include Asian-Americans

INTERNATIONAL

Most		Least
WASHINGTON	40%	VIRGINIA
CARNEGIE MELLON		DARTMOUTH
MARYLAND	39	TEXAS
NYU, MIT	37	

Most
COLUMBIA, N. CAROLINA
BERKELEY, WASHINGTON,
WISCONSIN

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All buttons should be t

You shouldn't have to n

use a wireless phone. Ti

digital phones the Navi-Key—a sin

feature and function. Guess you



COMPETITIVE ATMOSPHERE*

Most	Least
HARVARD	DARTMOUTH
PURDUE	YALE
WISCONSIN	BERKELEY

*Emphasis on individual achievement relative to teamwork, from student survey



USE OF TECHNOLOGY*

Most effective Least effective

CARNEGIE MELLON	STANFORD
UCLA	COLUMBIA
DARTMOUTH	MICHIGAN

*Based on technology related questions in student survey

32%
of schools require
a separate business
ethics course

The Classroom

MEDIAN PRE-MBA SALARIES

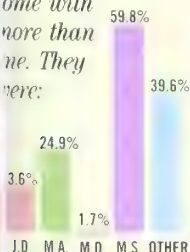
Highest

HARVARD	\$60,000
STANFORD	55,000
DARTMOUTH, WHARTON	50,000

Lowest

WISCONSIN	\$30,000
WASHINGTON	32,000
PURDUE	33,500

16.6% of MBAs entered
3-school with advanced degrees—
more than
one. They
were:



Least	
CAGO	22%
ELLON,	
RD	24



1988:

female

international

ENVIRONMENTAL FIRMS

Most intimate

WISCONSIN	(thousands)
MARYLAND	Bonus Total
PURDUE	\$28.0 \$124.3
	25.5 115.4
	21.4 114.7
Int	21.7 111.1

*Fewest schools

based on compa-

FINANCIAL COMPANIES

(thousands)
Bonus Total

\$33.2	\$110.4
33.8	110.3
30.1	109.0

SCHOOLS PROVIDE

Student
Highest

UCLA	19.3 93.7
CHICAGO	
CORNELL	
EIVING	
SATION	19,900

NUMBER 66.3%
BONUS 39.1

Highest	21.0
DARTMOUTH	17.0
TEXAS	13.9
MIT	12.7
	4.5
	11.0

'98
27%
international

MALE/FEMALE STARTING SALARIES

Median numbers, by career path
(thousands)

	Female	Male
ACCOUNTING	\$53	\$70
CONSULTING	90	90
ENTREPRENEURSHIP	71	75
FINANCE	75	75
HUMAN RESOURCES	62	60
INFORMATION TECHNOLOGY	75	79
MARKETING	70	70
NONPROFIT	53	50
OPERATIONS	70	75
AVERAGE	73	76

SCHOOLS WHOSE WOMEN GRADS EARN MORE THAN MEN

Median salary and bonus
(thousands)

	Women	Men
BERKELEY	\$100	\$95
CHICAGO	97	95
PURDUE	79	75
WASHINGTON	79	73
WISCONSIN	65	59

AVERAGE STUDENT DEBT (Thousands)

Most Least

CHICAGO	\$54.2	MARYLAND	\$19.2
HARVARD	51.4	WISCONSIN	21.6
WHARTON	50.7	PURDUE	21.8
AVERAGE	\$40.0		



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DATA: BUSINESS WEEK'S STUDENT SURVEYS, SCHOOL SURVEYS
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WEEK'S GUIDE TO THE BEST BUSINESS SCHOOLS



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Despite the global crisis, the struggle to hire MBAs is as fierce as ever—for now

The stock market is plummeting. The worldwide financial crisis deepens by the day. Corporate profits are slumping as companies from Gillette to 3M to Hewlett-Packard struggle with the double whammy of sharply lowered demand and a higher interest rate. And the finance industry—which employed 35% of all MBA graduates in the class of '98—has been particularly hard hit with the worst yet to come. Even the carnage, you might think, has ended the booming market seen in recent years for newly minted MBAs as well. But so far, you'd be wrong. Despite growing fears that the global financial turmoil could push the U.S. economy into layoffs and recession, corporate recruiters say that for now, the struggle to hire top-quality MBAs remains tough and competitive as ever.

Don't make no mistake about it: It is as fierce. Spend a day with Catherine H. Baker, vice-president in charge of worldwide recruiting at Mercer Management Consulting Inc., and that much is clear. As she and her team of Mercer recruiters head for a Sept. 22 presentation to first- and second-year students at the Wharton School, they're riding a Metro from Washington, D.C., to Philadelphia, rather than a warship. And they're using cell phones instead of two-way radios. But there's no doubt that the Wharton trip is the first shot in a campaign for what continue to be some of the most sought-after trophies of the late 1990s: graduating MBAs.

SKILLS. The reason is simple. Thanks to a tight job market for top managers in recent years, most of the action in the job-search mating dance has shifted from recruiters to students. The average member of the Class of 1999 at BUSINESS WEEK's top 25 B-schools boasted 3.2 job offers, up from 2.1 in 1992. The median starting salary-bonus rose to \$91,560 this year, up from two years ago. That doesn't include extras—ranging from free rent



to stock options to tuition paybacks—worth a median \$19,860. "The competition for MBAs has definitely quickened," says David L. Reed, director of global recruiting at Andersen Consulting. "It's as fierce as I've ever seen it."

He and others say that there is little reason to expect change, despite the global gloom and doom. In part, that's because companies are very happy with the skills today's MBAs possess. They have a rare mix of financial, technical, and communications skills that companies have trouble finding in engineers or other degree holders. Many companies are also still recovering from the disasters created when they downsized in the mid-1990s, firing far more middle managers than they should have. They vow not to repeat the error by cutting hiring too drastically. As costly as MBAs are, they're still cheaper than they will be later, when things improve. "You're making a long-term investment," says Peter D. Kiernan, co-head of the re-

RICHER LURES

Mercer's Baker has had to get creative to battle well-known competitors

cruting committee at Goldman, Sachs & Co. and co-chair of the communications, media, and entertainment banking group. "It's an illusion to think you can cut back now and be in a strong position when the markets begin to recover."

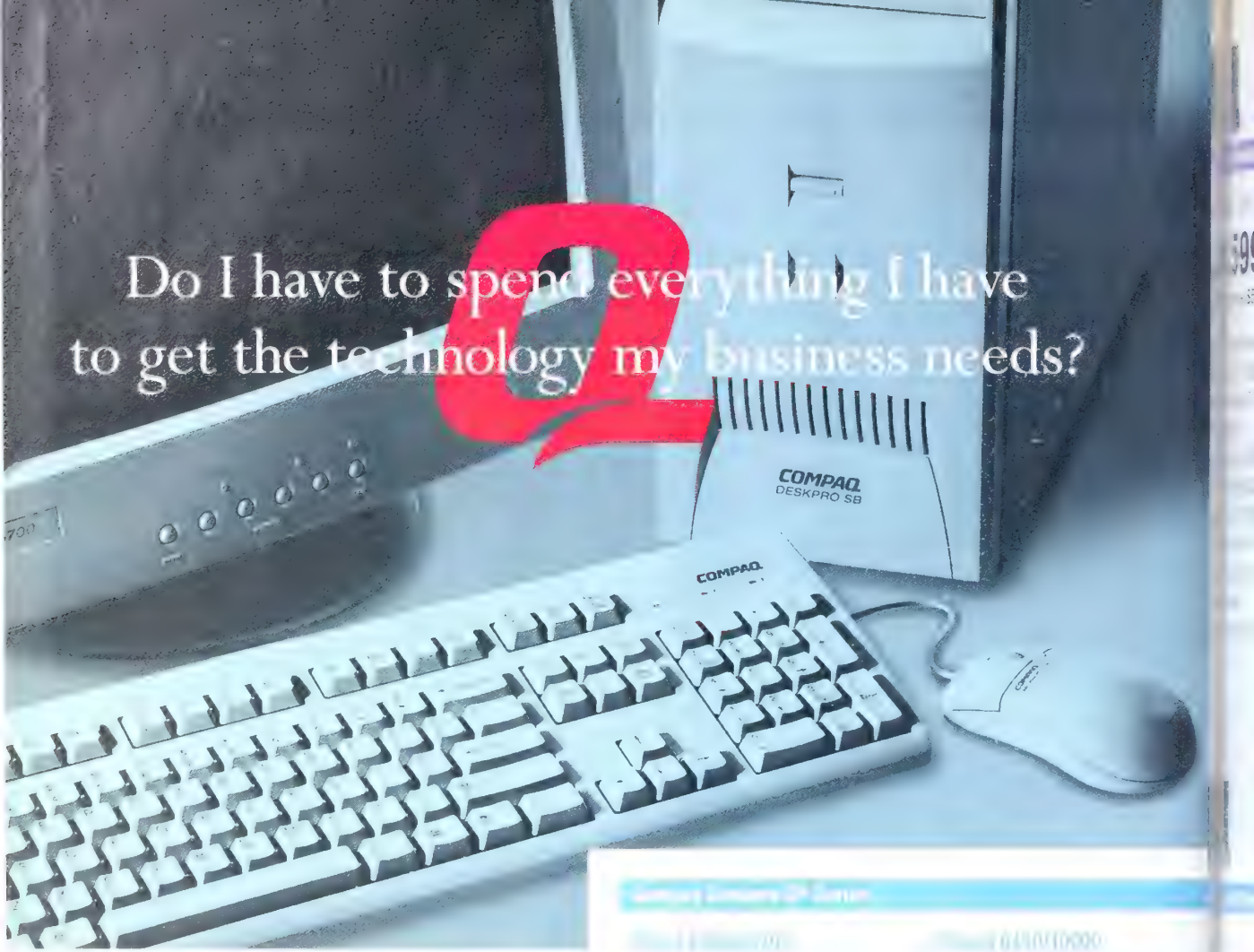
That's why most recruiters say they're sticking to their hiring plans for the Class of 1999. At the moment, how-

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ever, it's a painless pledge. Most don't have to decide how many to hire until it's time to extend offers—which won't happen for a few months. In the meantime, there's little reason to call off the endless rounds of meeting with students that begin anew every fall.

Indeed, thanks to the intense rivalry between the consulting and investment-banking firms, things look no different on the front lines than they've looked all year. The two fields pay the most, and—no surprise here—hire the most MBAs. In the Class of 1998, 63.3% chose one of the two industries. "We're all going after



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- K56flex modem⁴
- Integrated AC Adapter
- Multibay design
- 1-year limited warranty⁷

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Options

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- MMX™ Technology 233 MHz
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Better answers.

Many companies, burned by overzealous downsizing in the mid-'90s, are loath to cut hiring now

the same talent," says Baker, "so we're having to be more competitive."

That has made Baker's job even tougher, because Mercer's name is not as hallowed as that of rivals Boston Consulting Group or McKinsey & Co. To compete, Mercer has developed a strategy that resembles a brand-awareness campaign, complete with pitches aimed at different "sales channels"—otherwise

better glimpse of the P&G culture than a 45-minute meet-and-greet. Because recruiters only get a little time for official recruiting, some are now also holding meetings on broader subjects in which high-level execs present their firms' ideas—and drum their brands into the minds of young MBAs.

But getting in the door early and often is only the first phase of the fight. Some recruiters have also begun extending offers as quickly as possible in the fall in hopes of keeping targets from succumbing to later temptations. Sweeteners sometimes used by consultants and banks include tuition reimbursement for second-year students who sign early. "It's being used as an exploding bonus to preempt the competition," says Peter E. Veruki, director of career planning and placement at Vanderbilt University's Owen Graduate School of Management.

Yet there's not a lot of proof that such tactics have worked—at least for

one week, I saw the CEO of Morgan Stanley and the next week, a 24-year-old who started his own company," says Sheung L. Li, a recent Stanford graduate who turned down five offers before starting his own job search, landing at 3Com Corp. as a line manager. "On one hand, I can wait 15 years to be [the CEO guy]," he says. "On the other hand, I can be the guy who's four years younger than I am." Even the most selective firms had trouble. Goldman Sachs got acceptances from only 40% of its Stanford offers, relative to 80% at other top schools.

CHINA CARD. The frothy competition also led others to bend the rules to lure top candidates. After Kellogg's Erism rejected an offer from his summer employer, Kraft Foods Inc., Kraft asked him his plans. When he said he was going to China—job or no job—Kraft abandoned its practice of only hiring new MBAs for North American jobs. Soon Erism met the head of Kraft's

Greater China office, and Li is now an assistant product manager there. "The economy helped me," says Erism. "Kraft didn't get too [MBAs] they expected in North America, so they became over backward."

Will good times soon ensue? Already, the economic gyrations may have made some students think harder before rejecting offers for next summer. "The students sitting in the offers from investment banks who may last year have been pretty cocky and taken the

time are thinking about signing on," says Daniel R. Nagy, Fuqua's assistant dean for MBA programs.

Indeed, despite the insistence of Wall Street and elsewhere that no hiring slowdown is coming, some nervousness is beginning to permeate school campuses. Past history suggests that the investment banks are the first to slow hiring when economic problems hit. Although no recruiters have canceled any campus visits set for the fall, Nagy says, "daily, we hold our breath." He thinks if companies do come back, they'll do so mainly at schools further down the list. For now, however, recruiters are soldiering on—albeit both students and their B-schools hope they'll continue the onslaught.

By Jennifer Reingold
in Philadelphia

Special Report

THE BEST B-SCHOOLS

known as alums, students, and faculty—and a host of tactics that range from sending birthday cards and getting faculty to use books written by Mercer consultants, to the obligatory multimedia presentation.

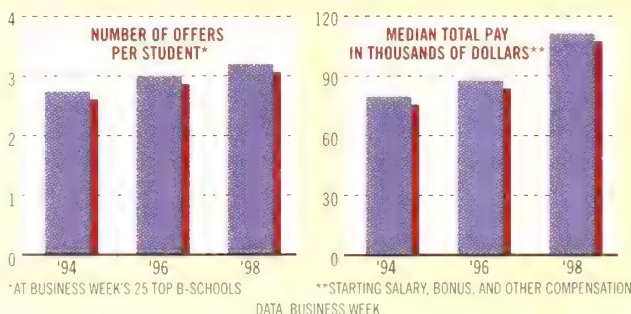
Baker also targets students, using far more sophisticated tools than Mercer did in the past. After parsing data showing that MBAs first hired as summer associates do better at the company than those hired after B-school, for example, she now works extra hard to get first-year students to take summer internships. "The old days of putting brochures out and buying enough shrimp and champagne to seduce [students] are gone," she says.

Not that such tactics can be ignored, however. For schools and recruiters alike, the rush begins in the fall, when scores of companies hurry to the campus to peddle their charms. Recruiters ask placement directors to set up meetings early, before students start to burn out. At Duke University's J.B. Fuqua School of Business, frantic recruiters began calling at 7 a.m. on Apr. 15, the day the fall interview schedule opened. Within five business days, 240 companies had been scheduled.

CLASS ACTION. That's why one preemptive tactic is gaining favor: getting to students through the sales pitch that's not really a pitch. Jeffrey D. Weedman, Procter & Gamble Co.'s licensing manager for corporate new ventures and the head of its recruiting at University of California at Los Angeles' John E. Anderson B-school, comes to school each winter to teach a case study on P&G to all first-year marketing classes, giving students a

Still a Seller's Market

MBA JOB OFFERS ARE UP... ...PUSHING PAY SKYWARD



the Class of '98. Recruiters say their "yields"—the number of acceptances relative to offers—dropped as students sat back and played it cool. "I was playing *Let's Make a Deal*," says Porter F. Erism, a recent grad of Northwestern's J.L. Kellogg Graduate School of Management. "In most years, you have to turn down door No. 1 and No. 2, and then you get the grand prize. This time it was like doors No. 9, 10, and 11."

Adding to the intensity was the increase in the number of students who rejected Corporate America for small startups and entrepreneurial ventures. Although the numbers remain small overall—4.5% in the top 25 schools—there were particularly large clusters at West Coast schools, where many students headed for Silicon Valley. "In



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Who's watching your network

THE MELTING POT STILL HAS A FEW LUMPS

Schools get mixed grades for smoothing foreign students' way—and fostering a global experience for Americans

Sunwook Kong was a little anxious when he showed up at Purdue University's Krannert Graduate School of Management from Seoul, South Korea, last fall. A media planner with little business experience, he was uncomfortable with his English and desperately feared speaking out in class—a hallmark of the U.S. B-school. "Koreans are accustomed to the kind of edu-

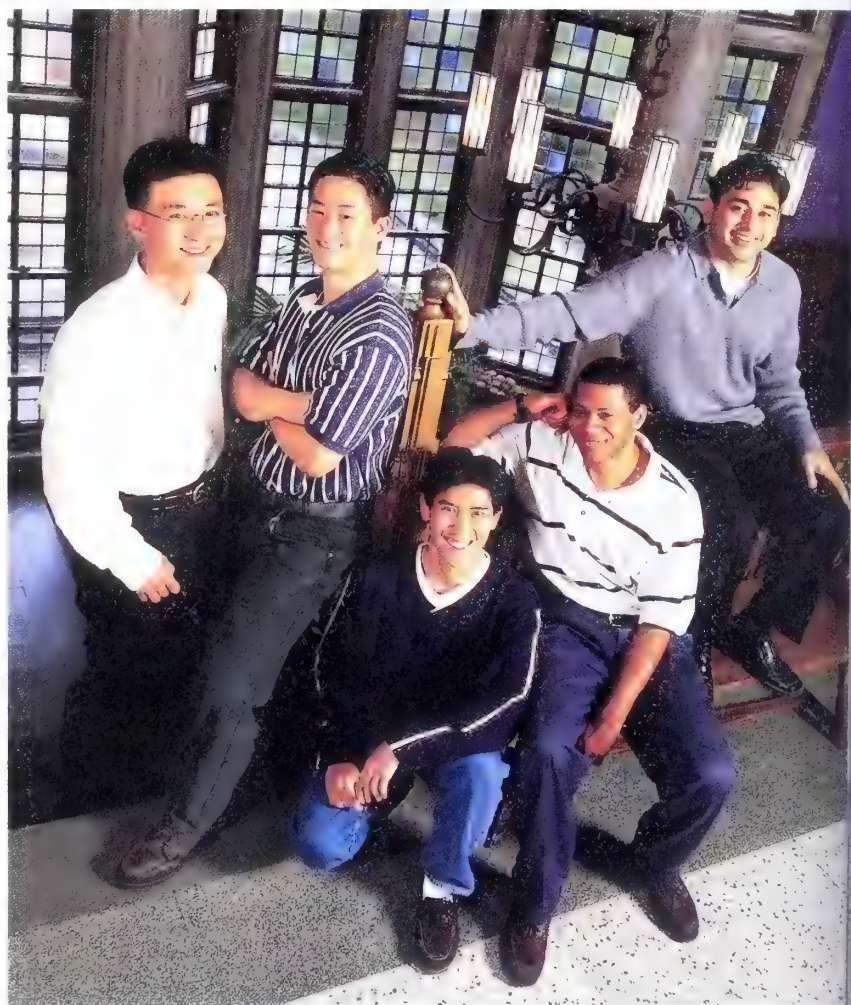
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cation that forces students to learn by heart," says Kong.

Thanks to his study team, he didn't have much of a choice. Kong's group—African-American Jevon Gordon; Jatuphat Tangkaravakoon, a Thai national; Chinese-American Steven H. Tsang; and Shawn A. Vij, an American born in India, forced Kong to do the writing and presentation part of a statistics project. The experience got Kong over his fear and helped galvanize the group. Now, they're not only effective study buddies, they're close pals. This Christmas, they're planning a trip to Asia to visit the homes of Tangkaravakoon and Kong. "They were friends outside of class," says Kong. "They showed me kindness."

"ABRASIVE." If only all foreign B-school students could say their experience had such a happy ending. Sure, nearly every B-school has gone global, hanging flags for each country represented, offering sushi and couscous nights, Latin dance parties, and study trips to Africa and China. But even as most have embraced classroom diversity as the best way to teach global management, deans at many B-schools have been negligent in making the reality live up to the promise for many students. Foreign students often still find themselves isolated academically and socially. Many also have trouble finding a job. And some domestic students, too, aren't getting the global in-



teraction and deep cultural understanding they thought they paid for.

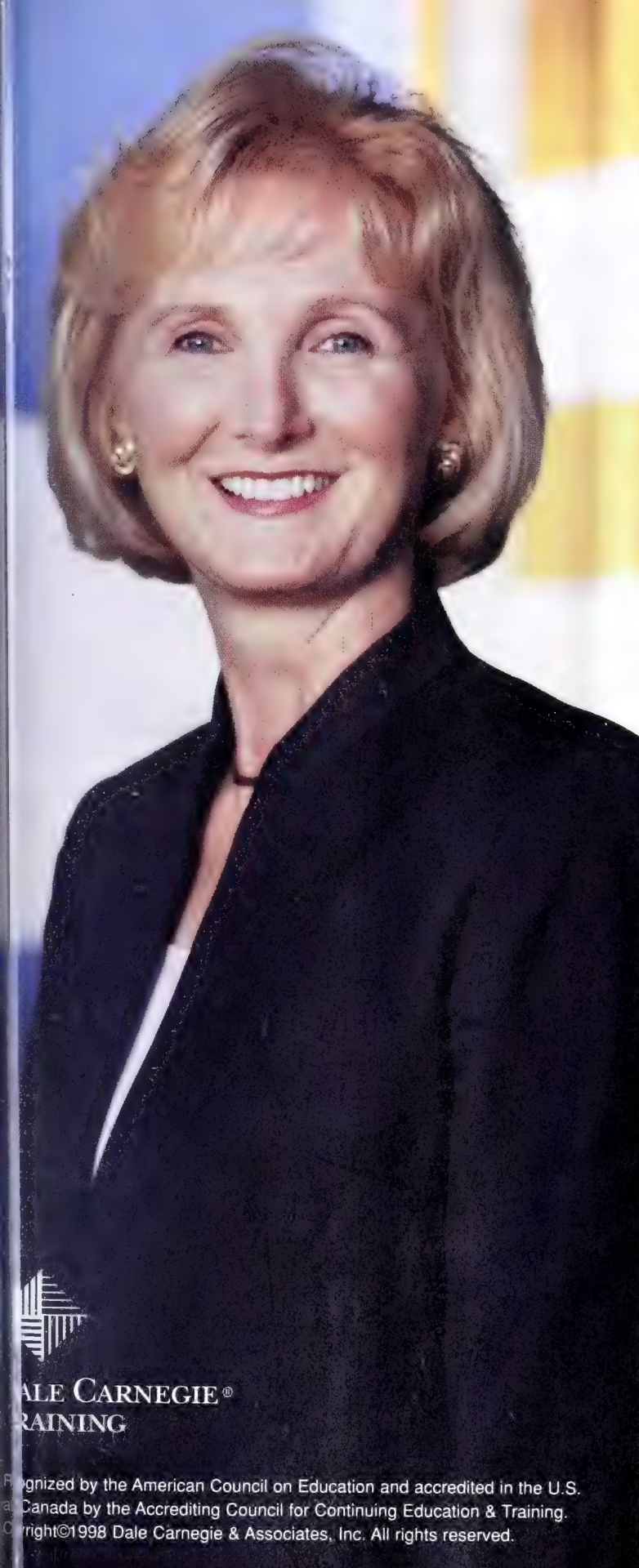
Start with the most obvious difficulty: The culture of most U.S. business schools remains strongly American, both in the classroom and out. Many foreign students aren't used to a system that requires class participation and direct communication. "At the beginning, I found the more outgoing nature of people in the U.S. abrasive," says Eamonn T. O'Sullivan, an Irish member of the class of 1998 at Dartmouth's Amos Tuck B-school. "I was uncomfortable being

SUCCESS STORY

Kong (left) was pushed to do presentations by his Purdue team

very up-front, saying, for example, 'I want to work with you in your study group.' With team-based projects an increasingly important part of coursework—and of each student's grade—reticence can be a problem.

Moreover, B-school places a huge premium on keg parties and ski trips to provide students the opportunity to make connections that will endure in the workplace. That's a very different idea of school than most non-Americans have. And it's not always clear that's important to show up for happy hour, even if you're a teetotaler. Because many of the international students are married, any free moment is likely to be spent at home with one's spouse, particularly if that person is new to the



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The pressure to socialize is very different from what most non-Americans are used to

country and doesn't have his or her own social network. "It wasn't impressed on [international students] that much of the MBA experience was a social aspect," says Sheung L. Li, a recent graduate of Stanford University's B-school born in Hong Kong but raised in the U.S. "There is a very aggressive social schedule here, and that's something most of the East Asian crowd stays out of."

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Such cultural misunderstandings can sometimes have serious consequences. At Harvard University's B-school, a case involving a Chinese student accused of plagiarism caused schoolwide tension in 1996-97 when the student defended himself in a mass E-mail message. He asserted that the problem was a cultural one and that he only did what was considered normal at home. After lengthy deliberation by the school, the student was expelled.

HIRING BLOCK. Finding a job, a key reason for going to B-school, is another challenge for international students. Placement offices tend to be set up for U.S.-based corporate recruiting, with few opportunities for students who wish to go back to their home countries. "If schools are claiming that 33% of the student body is international," says Piyush Dogra, a recent graduate of Northwestern's J.L. Kellogg School of Management originally from India, "definitely, 33% of the resources are not being spent to cater to their needs." Things are even tougher for those who wish to stay. Many U.S. companies, fearful of red tape, either won't hire non-U.S. nationals or will hire them only if they agree to work in their home countries. Andersen Consulting, for example, one of the largest hirers of new MBAs, recruits at more than 100 B-schools—but formally holds presentations for noncitizens at only eight of them.

There's a flip side to the international equation—the unmet expectations and growing frustration felt by American students. When students from abroad aren't encouraged to become active members of the class, Americans, too, are robbed of the window into other cultures that they've been told will be a key element of their education. "Domestic students made all the contribu-

tions to class discussion," says Tessa J. Jackson, a recent graduate of the University of California, Berkeley's Haas School. "So you don't know how business is conducted in Europe or the Pacific Rim." Jackson also laments the lack of international faculty at a school that heavily markets itself as global. "It's like a company where you have diversity at the bottom level and none in upper management," Jackson says.

Some U.S. students also resented slowing down for those with language difficulties and felt they bore an unfair burden in team projects. Says Rodney M. Laurenz, a 1998 graduate of Michigan State University's Eli Broad B-school: "On a team of six, there were generally two or three international students. You could assume that one couldn't do any reading or writing. You couldn't really learn from your peers."

At Michigan State, the problem was exacerbated because the school got more acceptances than it had planned on from

visa problems have access to lawyer kept on retainer by the university. Washington University's John M. Olin B-school, Tuck, and the University of Texas at Austin have recently hired full-time staffers to work exclusively on global placement. And for incoming foreign students with \$3,000 to spare, the Economics Institute, a Colorado-based nonprofit offered for the first time this past summer a five-week crash course called "Language & Culture of U.S. MBA Programs." Among the topics: the case-study method and how to join a team.

BONDING OPTION. In the classroom, assigned study teams are becoming more common as a way to force people to work together. At the University of Rochester's William E. Simon B-school, which boasts an international population approaching 50%, teams have been so successful that General Electric Co. gave the school a \$220,000 grant to study how teams learn. Even at the individualist University of Chicago, all students now

have the option to take their classes together in a cohort for the first quarter. More than half are doing so in the current semester.

Students, too, are coming up with schemes for getting people to interact at a deeper level. At Columbia University's B-school, student peer advisers are matched with international students to help solve problems ranging from getting a Social Security number to finding the best place for a good Filipino lunch. At Purdue, the school is moving to catch up with others by organizing an Asia

Business Club to provide, in Vij's words, "a comfort zone." And the Wharton Graduate Assn. (WGA) has launched a program this year called the Wharton World Tour, in which five regions of the world will be highlighted for one week at a time. In addition to cultural demonstrations, there will be a regional financial conference, a series of case studies, and extra classes. Each week will be sponsored by a company—preferably one with job links in the area. "When you see it coming to the classrooms," says WGA President and second-year student Cesar R. Conde, "people say, 'O.K., this is for real.'" The message: Living in a global village is easy. Becoming an integral part of one is anything but.

By Jennifer Reingold in New York

How Smart B-Schools Avoid Culture Shock

- ▶ Assign diverse study teams, particularly in the first few months
- ▶ Encourage international students to speak out, both for their own benefit and their classmates'
- ▶ Create a full-time staff position devoted to international job placement
- ▶ Offer many opportunities to socialize; include spouses or start a group for them

Asia, particularly mainland China. That created a few large subgroups of students who rarely interacted with others. "Socially and culturally, it was a real disappointment," says Orhan M. Ovatic, a recent Turkish-American graduate. "You hope to make contacts with people who are like-minded and will be in the global diaspora. But [this class was] cliquish and clannish." Dean James B. Henry admits that the school overshot. This year, the international percentage has dropped to 33% from 39%, and interviews are now required for all students, both to help test English skills in the case of foreigners, and, more generally, to get a better read on an applicant's personality.

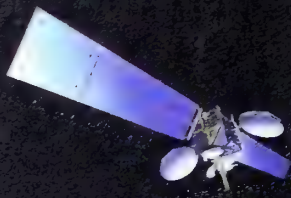
Many schools, cognizant of the frustration felt by both foreign and domestic students, are trying to become more responsive. At New York University's Stern School of Business, students with

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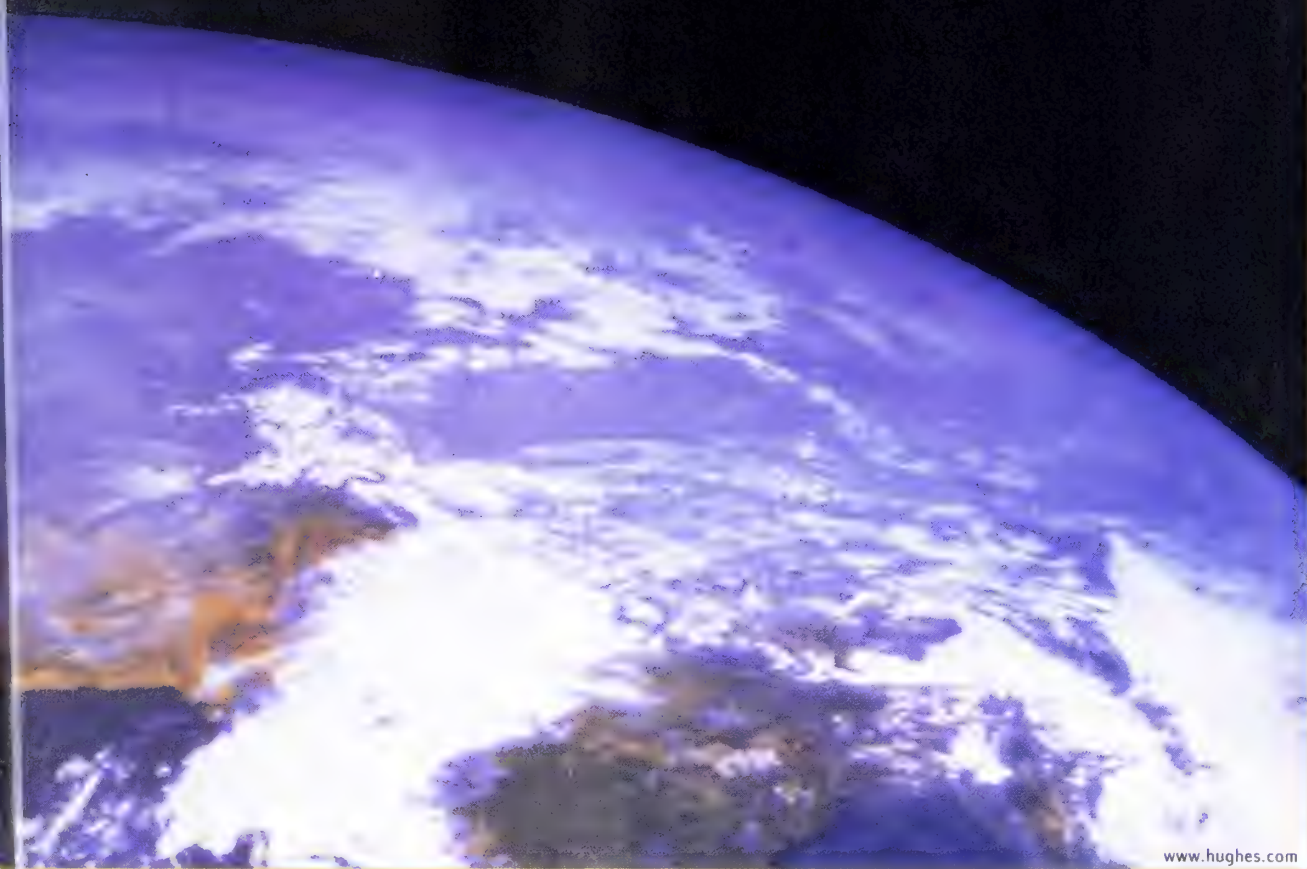


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ANTITRUST

THE BEST LEGAL SHOW IN TOWN

In Microsoft's upcoming trial, two star litigators square off

It was the type of situation most lawyers strive to avoid. On the morning of Sept. 11, New York-based attorney John L. Warden, who is leading Microsoft Corp.'s defense against the Justice Dept.'s landmark antitrust suit, found himself in the middle of a long wrangle with U.S. District Judge Thomas Penfield Jackson in a Washington, D.C., federal court.

The subject was Microsoft's contracts with companies that connect people with the Internet—agreements that trustbusters say illegally prevented these companies from promoting a rival Web browser made by Netscape Communications Corp. "If your browser is all that good, why do you need restrictive contracts to begin with?" Jackson asked Warden.

"Why does Coke have a deal with Disney? Why does any company have business agreements?" he asked. Warden, who is a partner at the Washington, D.C., law firm of Sullivan & Cromwell, said he had no answer. "I don't know," he said. "I don't know." Jackson, who has been a vocal critic of Microsoft's practices, said he was not a lawyer and was not a judge. "I am a judge," he said. "I am a judge." Warden, who is a partner at the Washington, D.C., law firm of Sullivan & Cromwell, said he had no answer. "I don't know," he said. "I don't know." Jackson, who has been a vocal critic of Microsoft's practices, said he was not a lawyer and was not a judge. "I am a judge," he said. "I am a judge."

Assure you they have... many

ognized, was the end of that. Bowing to the judge's "skepticism about my prior points," the experienced litigator quickly moved on. To nobody's surprise, Jackson later rejected Microsoft's motion to dismiss.

Welcome to John Warden's world. On Oct. 15, the 58-year-old trial lawyer is scheduled to begin defending Microsoft against a judge who is clearly hostile to

his client's arguments. As daunting as Warden's challenge is, though, it's not bigger than the one facing his adversary, Justice's lead litigator, David Boies. Although Boies, 57, appears to have Jackson's sympathy, his arguments are likely to be less popular with a more important audience: Jackson's superior, the jurists of the District of Columbia U.S. Court of Appeals. In June, the appeals court dealt a blow to Justice's case when it ruled in a related suit that judges should avoid second-guessing a company's software-design choices—a decision that appears to limit Jackson's ability to find wrongdoing by Microsoft.

The confrontation between the two veteran litigators should be quite a show. A renowned courtroom magician, Boies will need all of his skills to navigate around the seemingly forbidding appeals court decision. But already, he has shown a willingness to boldly revise his original



A COURTROOM MAGICIAN

VS.

AN UNFLAPPABLE VETERAN



JUSTICE'S DAVID BOIES

EDUCATION Northwestern University, 1964; Yale Law School, 1966

PROFESSIONAL A maverick who left blue-chip Cravath, Swaine & Moore in 1997 to start Boies & Schiller, a 24-lawyer litigation boutique

BIG CASES Successfully defended CBS in libel suit brought by General William Westmoreland; fought off Justice's decade-long breakup suit on behalf of IBM; represented Federal Deposit Insurance Corp. in suit against Michael Milken

SARTORIAL QUIRKS Partial to suits from Macy's and wearing his watch over his shirt sleeve

KEY CHALLENGE IN MICROSOFT CASE

Proving a pattern of predatory conduct by tying together anecdotes about Microsoft's dealings with several companies—evidence that Warden is sure to attack

MICROSOFT'S JOHN WARDEN

EDUCATION Harvard, 1962; University of Virginia Law School, 1965

PROFESSIONAL Lifelong veteran of Sullivan & Cromwell, the quintessential Wall Street firm

BIG CASES Defended Eastman Kodak in precedent-setting private antitrust suit; helped British Airways defend separate antitrust suits brought by US Airways and Virgin Atlantic Airways; defended Goldman Sachs in a class action accusing 36 brokerages of NASDAQ price-fixing

SARTORIAL QUIRKS Pinstripe suits and bowler hats

KEY CHALLENGE IN MICROSOFT CASE

Minimizing the damage from dozens of seemingly incriminating internal E-mail scolding trial judge Thomas Penfield Jackson—who has been hostile to Microsoft's case

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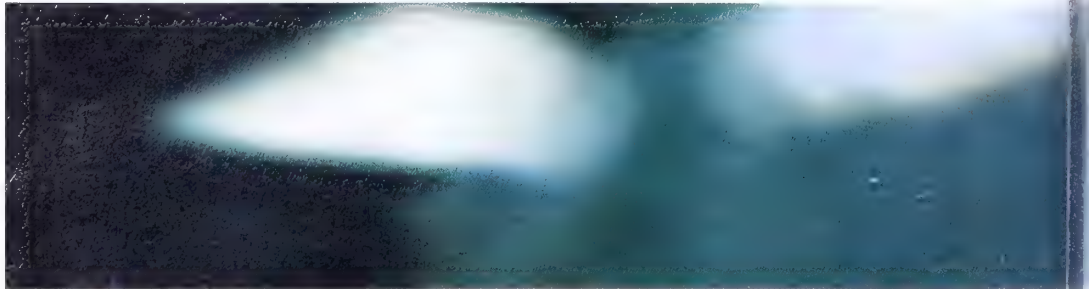

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Legal Affairs

strategy. Soon after the May appeals-court decision, he repositioned the government's suit away from a narrow focus on Microsoft's alleged mistreatment of Netscape toward a broader attack on its alleged pattern of bullying competitors.

Warden, meanwhile, will focus on shredding the government's evidence. While Boies tries to weave together testimony from Microsoft rivals and damaging internal E-mails into a portrait of a dangerous corporate predator, Warden will attack the government witnesses' credibility and attempt to demonstrate that the E-mails have been taken out of context. He will also hammer home the point that Microsoft's decision to combine the browser into the operating system helped consumers—and therefore, by definition, would not be illegal.

Both men have impressive portfolios. Although Warden is not as widely known as Boies, he put Sullivan & Cromwell on the antitrust map when he helped reverse a huge jury verdict against client Eastman Kodak Co. The private suit had accused Kodak of ille-

gally protecting its film monopoly by making new film that worked only with a new Instamatic camera, much as Microsoft is accused of tying its browser to the Windows operating system. After another firm botched the trial, Warden's appellate work led to a 1979 circuit court ruling that "any firm, even a monopolist, may generally bring its product to mar-

chemistry with the judge," says Paul C. Jasinski, general counsel for British Airways in the U.S., who has tapped Warden to defend antitrust suits filed against the British carrier by Virgin Atlantic Airways and US Airways.

Away from the courtroom, Warden enjoys playing tennis and bridge. A board member of New York's American Ballet Theater, he's fond of thrillers but hates John Grisham novels. "I found his first book ridiculous. I never picked up another one," Warden laughs.

Like Warden, who is a casual friend, Boies has participated in some of the most important antitrust cases in recent history. The Sycamore (Ill.) native first rose to prominence when he helped IBM defeat the government in its epic suit against the company, which dealt with business practices similar to those in the Microsoft case. "This is a guy who knows every trick that a monopolist can play in litigation," says Alan K. McAdams, a Cornell University professor who was Justice's chief economist on the IBM suit, during which he was cross-examined by Boies.

“ [Boies] is a guy who knows every trick a monopolist can play in litigation ”

— ALAN K. McADAMS, Cornell University

ket whenever and however it chooses.”

An unflappable advocate who is partial to Saville Row-like pinstripe suits and bowler hats, Warden was tapped to take over Microsoft's defense after Jackson's temper boiled over in dealing with the company's previous attorney, Sullivan & Cromwell's aggressive Richard J. Urowsky. Already, Warden has rebuilt Microsoft's credibility with Jackson by toning down its once-shrill attacks on the government and cooperating more fully with courtroom edicts. "One of his strengths is establishing



Both of these men are traveling 2,000 miles a week.

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Boies can be a cunning tactician. In 1995, he successfully defended CBS in a libel suit brought by General William Westmoreland. George Vradenburg, who hired Boies to defend CBS in that suit, recalls that the judge had imposed a 100-hour limit on each side's presentation. Every evening, he says, Boies would compliment Westmoreland's attorney on his cross-examination of the longest witness for the day. "Why? David Boies hated the other attorney to use up all the time with one of the least vulnerable witnesses," says Vradenburg, now general counsel for America Online Inc.

AGENT. Frequently teased for his expensive Macy's suits and wearing his Casio watch over his sleeve, Boies is, as a corporate attorney, something of a maverick. In 1997, when New York's prestigious Cravath, Swaine & Moore refused to let him represent the Yankees in an antitrust dispute because of a long-term conflicting relationship with Time Warner Inc. (owner of the New York Yankees), he left and started his own litigation boutique, Boies & Schiller

in Armonk, N.Y. For the Justice Dept., because "this is one of the most interesting pieces of litigation going on right now," Boies agreed to halve the usual \$550-an-hour rate he charges corporate clients. He unwinds by four-wheeling in his jeep and gambling in Las Vegas.

Boies is admired for his photographic memory and his ability to cut through a

proving that each of Microsoft's meetings with Netscape, Intel, Apple Computer, and other companies was conducted for illegal gain—especially with a 12-witness limit on each side. Warden has argued that such meetings between competitors are common practice in high tech and never harmed rivals. Says Chicago antitrust attorney Hillard M.

Sterling: "Justice has a steep uphill climb in tying these anecdotes together into a coherent theme of anticompetitive behavior."

Although a last-minute settlement is always possible, both camps' public statements suggest that any middle ground will be hard to find. And that means David Boies and John Warden may be spending a lot of time together before Judge Jackson—perhaps continuing their tug-of-war all the way to the Supreme Court.

By Susan Garland in Washington

BusinessWeek **ONLINE**

For ongoing coverage of the Microsoft trial, go to www.businessweek.com and www.courtstv.com

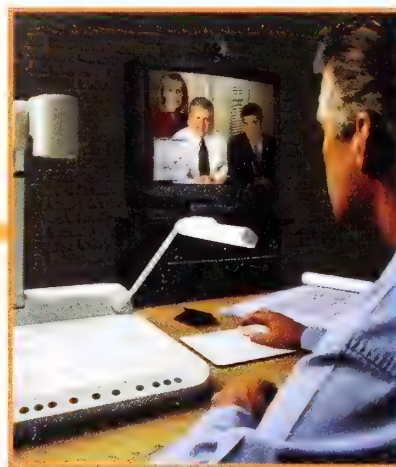
“One of [Warden’s] strengths is establishing chemistry with the judge”

—PAUL JASINSKI, British Airways

morass of minutiae to present the big picture—an important skill in this case, which could easily bog down in technical jargon. In court arguments and briefs for the case, Boies has tried to tell a simple story: that Microsoft engaged in illegal acts to protect its monopoly in the Windows operating system. "The core issues that the courts have to decide are very simple," Boies says, adding that he can't afford to "get lost in some of the details."

But for all his cleverness in the courtroom, Boies will have a tough time

meeting. Which one would you rather be?



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DISPLAYS

FLATTER, BRIGHTER—AND EASY TO MAKE?

A new screen technology has the industry charged up

In a crowded room, amid the clink of champagne glasses, a woman stares at a new kind of postcard, thinks for a minute, and says "Wish you were here." On the way home that evening, she slips the card into a mailbox. A few days later and half a world away, a friend flicks a switch on the card, hears the clink of the glasses, and watches the sender and her friends jostle in front of the card. He chuckles, and forgives the cliché.

"Video postcards" won't be ready in time to commemorate that big millennium party you're planning. But they may arrive early in the next century, thanks to a global race to perfect a powerful new kind of flat display. The screens are known as OLEDs, for organic light-emitting diodes. They'll be light and bright, ultrathin and flexible, and easier to produce than most other types of flat screens for computers and TVs. And since the diodes can also act as photodetectors, the new screens may someday be able to capture and store images as well as play them back.

POSSIBILITIES. That's the concept behind video postcards. And the technology has inspired many other flights of engineering fancy. Designers at Philips Electronics—a leading player in this budding field—have sketched out newfangled laptops with screens like delicate sails that furl, so they take up less space. Marketeers at Cambridge Display Technology, an OLED start-up in Cambridge,

England, talk of long, thin, luminescent ceiling panels that could replace the heavy lighting fixtures on jetliner ceilings. Product designers also talk of giant video screens that consumers could one day roll like wallpaper across an entire living room wall. From "smart maps" linked to databases on the Net to glowing neon stock tickers or poetry banners stitched into T-shirts, "the possibilities are literally endless," declares Cambridge Display CEO Daniel R. Chapchal.

Like the more common light-emitting diodes that are used for dot-matrix-style message boards at airports, OLEDs rely on materials that give off light when tweaked with an electric current. But these new screens are far more versatile than the crystalline arrays that make up message boards. In OLEDs, the light-

emitting materials are deposited in films and combined with a matrix of electronic circuits that switch on individual picture elements, or pixels. The first applications for such screens are unglorious backlights for liquid-crystal displays (LCDs) in notebooks. But within two years, OLEDs will start competing with LCDs in handheld computers, phones, and camcorders.

For the more exotic applications, unfurling notebook screens, many researchers are banking on a plastic variety of OLED—sometimes called light-emitting polymers. Here, the glowing organic materials consist of long, repetitive chains of large molecules that are suspended in solution and spun or sprayed onto a substrate. No fewer than 65 companies have jumped into the field, including Philips, Lucent Technologies, DuPont, and Dow Chemical, as well as a host of Japanese giants. "This is probably the hottest research area in the whole field of flat-panel displays," says David E. Mentley, vice-president of display-industry research at Stanford Resources Inc. in San Jose, Calif.

ELEGANCE. For now, Mentley chalks off wall-size screens to hyperactive imaginations. But even without them, he says, OLED sales are likely to soar from almost nothing today to \$400 million by 2004. That's small change compared with

sales of LCDs, which will hit \$12.4 billion this year, but OLEDs are on a steep ramp-up. "I don't think there has ever been a new display technology that went from nothing to 65 players in just three or four years," he says.

The excitement is easy to explain. Despite the efforts of display titans such as Sharp, NEC, Toshiba, and Hitachi, LCDs have never been an elegant solution to the flat-display challenge. They consist of many layers of materials and electronics, assembled in a long and costly series of manufacturing steps. More important, liquid crystals don't actually emit light. They simply shutter light passing from a fluorescent tube at the back of

THE PLUSES OF PLASTIC DISPLAYS

FLEXIBLE



Advantage Durable displays can be fashioned on novel substrates, including plastic, instead of glass.

Dream Products Clothlike screens that roll up like scrolls, reducing the size of laptop computers. Luminescent strips could also be sewn into clothing for decoration or advertising.

THIN AND INEXPENSIVE



Advantage Produced in fewer layers than LCDs, with fewer manufacturing steps. Don't need backlights.

Dream Products Devices will be very light and cheap, paving the way for video "postcards" that could record and display five-second videos. You create a video message and then drop it in the mail.

SCALABLE PICTURE ELEMENTS



Advantage Pixels—dots of colored light—are deposited in variable sizes and shapes.

Dream Products Could lead to giant video screens applied like wallpaper to living room walls. Aircraft makers could replace heavy ceiling lights with one long ceiling panel.

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-J.B., Apalachicola, FL

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Shadow of Bobby Jones Falls Across

THE TOUR Championship

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is being held at Atlanta's East Lake Golf Club, the home course of the immortal Bobby Jones.

East Lake Golf Club was founded in 1904. It's where Jones moved with his family in 1907, when he was five years old. And it's where the golfing legend learned to play the game *oh so well*.

In an amateur career filled with many highlights, one clearly stands out. In 1930, Jones won what was

East Lake. One will walk away with the \$720,000 first prize that's part of a \$4-million purse.

Defending his title, not always a given at THE TOUR Championship, which had five winners fail to qualify the next year, will be David Duval. Last year, in the second TOUR Championship play at Champions, Duval posted a one-stroke victory over Jim Furyk. PGA Championship winner Davis Love III was two strokes back. Will Duval, a four-time All-American at nearby Georgia Tech, enjoy something of a "home-course advantage" at the first TOUR Championship held in Atlanta?



Tiger Woods



Mark O'Meara

Official
PGA TOUR
Event

David Duval

In its 11 previous playings, THE TOUR Championship has been contested at some of America's most famous golf courses: Oak Hills Country Club in San Antonio, TX; Pebble Beach Golf Links on California's Monterey Peninsula; Harbour Town Golf Links on Hilton Head Island, SC; Champions Golf Club in Houston; Pinchurst No. 2 in the Sandhills of North Carolina; San Francisco's Olympic Club and Southern Hills Country Club in Tulsa, OK.

A very large shadow will fall across the 12th TOUR Championship, presented by Mercedes-Benz of North America and Southern Company. For this year's season-ending tournament, featuring the top 30 PGA TOUR members on the official TOUR money list,

then considered the Grand Slam of Golf – the U.S. Amateur, U.S. Open, British Amateur and British Open. That feat is considered one of the greatest accomplishments in golf history.

Legendary golf course architect Donald Ross redesigned the course in 1914. In 1963, East Lake was the site of the 15th Ryder Cup Matches, won by the United States over Great Britain and Ireland, 23-9.

The week of Oct. 26-Nov. 1, some of the TOUR's finest players will look to leave their own mark on

Last fall, Duval was on a definite roll when he arrived in Houston. In his two previous starts, he won the Michelob Championship at Kingsmill and the Walt Disney World/Oldsmobile Classic his first and second TOUR titles. Winning THE TOUR Championship gave him a 3-for-3 finish in 1997. Not a bad stretch at any point along the line, let alone to conclude the season.

"I don't think you can ever envision a streak, winning three starts in a row," Duval said following his victory. "Three victories in a row, no matter how they spaced out, is something I think that you look back on as a great year."

"I'm just glad I get that trophy," added Duval, who earned \$720,000 for his win. "I think, because of the size of the purse and because of the field and the golf

THE TOUR Championship Television Schedule

Thursday, October 29

First Round of Competition

ESPN - 7:00-5:00 p.m. EST

Friday, October 30

Second Round of Competition

ESPN - 2:00-5:00 p.m. EST

Saturday, October 31

Third Round of Competition

ABC - 1:30-3:30 p.m. EST

Sunday, November 1

Final Round of Competition

ABC - 2:00-5:00 p.m. EST

rise on which this tournament is held, is certainly one of the biggest and most important tournaments of the year. Think, if anything, that makes you realize how big a tournament it is. You don't think as much of the money."

THE TOUR Championship, presented by Southern Company and Mercedes-Benz of North America, provides the



Classic in February, the Shell Houston Open in May and the NEC World Series of Golf in August. Couples captured the season's second event, the Bob Hope Chrysler Classic, then won the Memorial Tournament. Mayfair, who won the 1995 TOUR Championship by three strokes over Steve Elkington and Corey Pavin, defeated Tiger Woods in a playoff to win the Nissan Open, then followed with a victory at the Buick Open.

Mickelson took one of the more

unusual routes to yet another exciting TOUR season. It also should serve to mine the winners of the Jack Nicklaus Player of the Year Award; the Arnold Palmer Award, which goes to the TOUR's leading money-winner; and the Byron Nelson Award, which goes to the scoring leader. Additionally, the tournament likely will decide the winner of the season-long MasterCard PGA TOUR Charity Team competition for TOUR events.

"THE TOUR Championship epitomizes golf competition at its best," said PGA TOUR Commissioner Tim Finchem. "So is doing exactly what it was intended to do: provide a fitting climax to the TOUR season."

Very fall since 1987, the 30 players had the best years on TOUR have led skills with one another over the game's toughest challenges. And results have been skillful shorting, close finishes and definite fan interest," added Finchem.

The TOUR Championships have ended playoffs, including four in a row from 1987 through 1991. In the most recent of, Mark McCumber defeated Fuzzy Zoeller in 1994.

This year, six players — Duval, Fred Couples, Mark O'Meara, Billy Mayfair, Phil Mickelson and Vijay Singh — were the winners on TOUR (through 1991). Duval enjoyed last year's finish at the Tucson Chrysler

unusual routes to his second win: by waiting more than half a year. The 28-year-old lefthander began the season by winning the Mercedes Championships. Then, on Aug. 17, he won the weather-delayed AT&T Pebble Beach National Pro-Am more than six months after it began. Singh wrapped his two victories around Mickelson's second one, winning the PGA Championship the day before Phil won at Pebble Beach, then following one week later with a win at the Sprint International.

One of the season's biggest stories, however, was O'Meara. The 41-year-old followed his first major championship at the Masters Tournament with yet another at the British Open, making him the oldest player to win two majors in the same year.

Justin Leonard captured THE PLAYERS Championship in March, continuing the come-from-behind heroics that produced 1997 victories at the Kemper Open and the British Open. In each case, the 26-year-old Texan came from five strokes behind entering the final round to claim the victory.

Along with its strength of field and challenging venue, corporate sponsorship

is another key element for THE TOUR Championship. Mercedes-Benz of North America, which also sponsors the season-opening Mercedes Championships, is serving as a presenting cosponsor for the fourth consecutive year.

Making its first sponsorship appearance at the 1998 TOUR Championship is Southern Company. Southern Company (NYSE: SO), the largest producer of electricity in the United States, is the parent firm of Alabama Power, Georgia Power, Gulf Power, Mississippi Power and Savannah Electric. Based in Atlanta, Southern Company, through its Southern Energy Inc. subsidiary, supplies electricity in 10 countries on four continents. Southern Company also provides energy-related marketing, trading and technical services and Southern LINC wireless telecommunications.

From a television standpoint, ESPN and ABC will provide 11 hours of coverage of THE TOUR Championship, which will be broadcast internationally by Fox Sports International, BSkyB and NHK.

In 1999, the tournament returns to Champions Golf Club for a third

THE TOUR Championship Results

Oak Hills CC, San Antonio, TX		
1987	Tom Watson	Two strokes over Chip Beck
Pebble Beach GL, Pebble Beach, CA		
1988	Curtis Strange	Won playoff over Tom Kite
Harbour Town GL, Hilton Head Island, SC		
1989	Tom Kite	Won playoff over Payne Stewart
Champions GC, Houston, TX		
1990	Jodie Mudd	Won playoff over Billy Mayfair
Pinehurst No. 2, Pinehurst, NC		
1991	Craig Stadler	Won playoff over Russ Cochran
1992	Paul Azinger	Three strokes over Lee Janzen and Corey Pavin
The Olympic Club, San Francisco, CA		
1993	Jim Gallagher, Jr.	One stroke over David Frost, John Huston, Greg Norman and Scott Simpson
1994	Mark McCumber	Won playoff over Fuzzy Zoeller
Southern Hills CC, Tulsa, OK		
1995	Billy Mayfair	Three strokes over Steve Elkington and Corey Pavin
1996	Tom Lehman	Six strokes over Brad Faxon
Champions GC, Houston, TX		
1997	David Duval	One stroke over Jim Furyk

time, the most for any golf course. Champions also has been the site of five Houston Champions International, the 1967 Ryder Cup, 1969 U.S. Open and 1993 U.S. Amateur. Jack Burke, Jr., who won the Masters Tournament and PGA Championship in 1956, is the president and majority owner of Champions.

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the screen through a complicated array of polarizers and color filters. And LEDs rarely look good viewed from the side.

Compared to all that, an OLED is elegance itself. It requires just a few layers of glowing material. And just as pigments come in many colors, different organic molecules emit their own light in different colors, when excited by voltage. So it's good-bye to filters, polarizers, or backlights. What's more, the molecules can be deposited on substrates using straightforward techniques borrowed from inkjet printing. They don't require the expensive vacuum manufacturing gear found on LCD production lines. And the resulting screens look great from any angle.

Some of the first OLED breakthroughs came from Eastman Kodak Co. research labs. In the mid-1980s, the company patented techniques for depositing small organic molecules on a substrate. Today, Kodak maintains a team of about 40 OLED researchers. And it has licensed its technology to Pioneer Electronics, which has demonstrated a full-color, 2-inch display for car stereos.

FAST MOVES. But the biggest breakthrough came in 1989, when Cambridge University physicist Richard H. Friend and his colleagues discovered light-emitting organic polymers. They formed Cambridge Display Technology to turn these into OLEDs, licensing the technology to Philips, Seiko Epson, and Hoechst, while doing joint-development work with DuPont. Seiko developed an inkjet production technique and quickly demonstrated 2-inch prototypes. Now Seiko is gearing up to make OLED screens for notebooks. Says physicist Friend: "We've been able to move much faster than I ever thought possible."

OLED makers face plenty of hurdles. With dozens of manufacturers locked in fierce competition, LCD screen quality keeps improving while prices drop. OLED ventures will also have to beat a host of rival technologies. When it comes to flat, wall-hanging TVs, for example, the front-runners are plasma displays, which have drawn huge investments from the likes of Fujitsu, NEC, and Sharp.

Prices for such displays, however, are \$7,000 and up. That's not at all the price of economics Richard Friend and other OLED pioneers have in mind. "It's so fanciful," says Friend, "to think of any electronic circuits that are no more difficult to make than the glossy Sunday newspaper supplement, which you throw away on Monday." Or recycle, if plastic wins the day. The flights of fancy are only just begun.

By Neil Gross in New York

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Developments to Watch

EDITED BY CATHERINE ARNST

WHO DECIDES WHO'S FIRST IN LINE FOR KIDNEYS?

THERE IS A CONTROVERSY raging in the transplant world right now over which patients receive scarce organs. The Health & Human Services Dept. issued regulations in March requiring nationwide standards for allocating organs based on medical need to ensure "a level playing field" for patients, no matter where they are treated. But several states and transplant centers have taken legal action to keep the old system, in which organs are allocated by regions and individual hospitals have their own criteria to determine which patients get priority. No matter which side prevails, minorities, women, and the poor may still lose out—because they often don't get on the lists in the first place.

Drs. Caleb Alexander and Ahwini Sehgal of Case Western Reserve University in Cleveland studied the records of 7,125 patients receiving kidney dialysis from 1993 to 1996 in Indiana, Kentucky, and Ohio. Reporting in the *Journal of the American Medical Assn.* (JAMA), they found that when all other factors, such as age, overall health, and reason for kidney failure, were equal, African Americans were 32% less likely than whites to complete a pretransplant workup—a requirement for being placed on a waiting list. Women were 10% less likely to complete the preliminary step than men, and poor patients were 23% less likely than the well off. Lisa Kory, executive director of the patient advocacy group Transplant Recipients International Organization (TRIO), says the study provides further evidence that "there has got to be standardized listing criteria." □

TWILIGHT OF THE GOURDS

HERE'S A SCARY HALLOWEEN STORY: A MYSTERIOUS DISEASE IS attacking the symbol of the holiday—the pumpkin. For the second year in a row, the plague is striking pumpkins across New York, turning plant leaves yellow and causing the fruit to rot. The condition has already destroyed 700 acres of pumpkin fields and has been spotted in cucumbers and squashes as well.



Botanists at Cornell University in Ithaca, N. Y., have yet to come up with the cause of the blight. When it was first discovered a year ago, they thought it was yellow vine disease, a scourge that caused substantial damage to watermelons in Oklahoma and Texas in 1991. Lab experiments, however, ruled that out. Now they suspect some new bacterium. Thomas A. Zitter, a plant pathology professor who heads the investigating team, says the microbe most likely spends the winter in an insect body, a weed, or a shrub.

Once unleashed, the blight turns into the Freddie Kruger of the pumpkin patch. When Zitter first spotted the disease in 1997, only a few pumpkin fields in one county were affected. This year, crops in five counties suffered damage, and Zitter expects the disease soon to spread to neighboring states—haunting pumpkin farmers everywhere. *Nellie Andreeva*

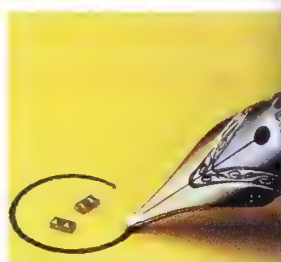
THE NEWEST WRINKLE IN SKIN LASERS

WHEN SKIN RESURFACING LASERS BURST ONTO THE dermatological scene four years ago as a way to zap wrinkles, face-lifts seemed headed for obsolescence. By delivering a precise burst of light to a wrinkle, the laser heats up the skin enough to stimulate the production of new collagen, plumping up the crease.

But patients seeking smoother faces have to endure weeks of discomfort and months of redness as they heal. The latest effort to improve the process is a "tunable" skin resurfacing laser, introduced on Oct. 2 by Cynosure Inc. in Chelmsford, Mass. Surgeons can constantly recalibrate the intensity of the laser, dubbed the CO₂, delivering short bursts of energy to erase crow's feet or longer bursts to smooth out deep wrinkles.

Clinical trials indicate that by varying the laser's intensity, doctors are able to promote beneficial collagen growth more effectively at reduced healing time. Dr. David D. McDaniel, an independent dermatologist in Virginia Beach, Va., who participated in the clinical trials, says "the CO₂ appears to be just as effective as earlier lasers at reducing wrinkles, but people healed quicker, with less discomfort." However, he cautioned, "it still hurts." That's the price of looking forever young, it seems.

Paul Judge



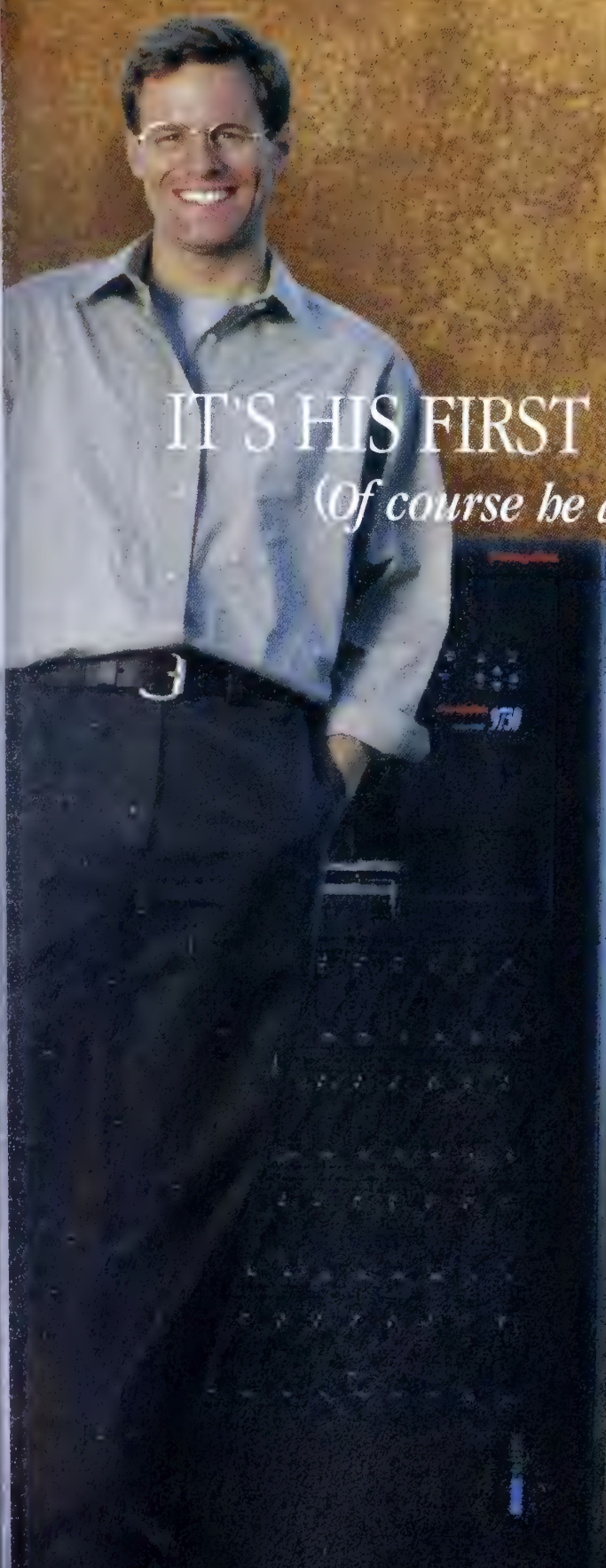
GOOD CHIPS COME IN SMALLER PACKAGES

CHIP PACKAGES ARE A PROS and cons but essential part of the semiconductor business. Usually made of plastic or ceramic, they seal out heat and moisture but also swell the size of the chip, forcing consumer goods designers to sacrifice performance for fit. Now, an ultrathin package, the size of a pin-head, is poised to bring about smarter, cheaper, and more power-efficient devices.

The package from Dallas Semiconductor Corp. consists of minute layers of plastic film and metals wrapped around digital sensors, switches, and timers—sort of like a plastic-wrapped sandwich. The combination is only a tenth the size of older packages. "They should find a lot of happy homes for these devices," says James Turley, analyst at market research firm MicroDesign Resources. The company predicts that smart cell-phone batteries, printer cartridges, and medical gear will all use its packages.

To showcase the package's durability, Dallas Semiconductor and Texas Instruments Inc. in Dallas devised a digital roof weather vane with tiny sensors to track wind speed, direction, and temperature. As many as 100 of the devices can be connected to a PC or a single phone line—allowing home owners to create their own weather-forecasting works. *Gary McWilliam*

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PLAYING THE MARKET WITH CAMPAIGN CASH

Candidates are investing—with varying degrees of success

When Jeffrey J. Parker started investing his company's excess cash in the stock market back in June of 1996, he didn't even tell the boss. Working with a discount broker, Parker paid \$58,000 for shares in a software company. Soon, he bought shares in other tech companies, then exotic equity derivatives, until he had nearly \$240,000 tied up. When he sold everything 14 months later, the boss was pleased: Trading profits totaled \$143,000—a 60% gain.

Parker's market dabbling wouldn't be so unusual except that his employer is Representative Bob Inglis (R-S.C.), who is trying to unseat Democratic Senator Ernest F. Hollings. And the company is Inglis' campaign committee. Its capital: campaign contributions.

Inglis isn't the only candidate to use the stock market to fatten a campaign chest. The practice isn't illegal, and it paid off big for a handful of politicians as the bull market was roaring ahead. It certainly beats rubber-chicken dinners.

CONFLICTS. On the other hand, there's the chance—especially in today's volatile market—of losing those contributions. Representative Tom Campbell (R-Calif.) lost almost one-third of the money he invested in equity mutual funds over the past 18 months. Then there are ethical hazards—the potential for conflict of interest. If companies they invest in seek special favors, or legislation threatens their bottom lines, lawmakers might be tempted to vote their portfolios. Investing campaign funds “increases the incestuous relationship between deep-pocketed special interests and politicians,” says Charles Lewis, executive director of the nonpartisan Center for Public Integrity.

To avoid such conflicts, Inglis instructed Parker not to tell him which companies he had invested in. Parker, the campaign's treasurer, bought 9,000 shares of Datastream Systems Inc., based in Greenville, S.C., just before it posted quarterly earnings that beat analysts' projections and just prior to several new-prod-

Keep up Progress!



WINNERS AND LOSERS

REPRESENTATIVE BOB INGLIS (R-S.C.) invested \$240,000 in eight companies from June '96 to August '97 and showed a \$143,000 gain, or 60%.

REPRESENTATIVE PETER DEUTSCH (D-FLA.) invested \$600,000 over 18 months ending in June '98 in large-cap stocks, for about a 40% gain.

REPRESENTATIVE TOM CAMPBELL (R-CALIF.) invested \$200,000 from February '97 to September '98 in mutual funds managed by Robertson Stephens Investment Management. He showed a net loss of \$63,000.

DATA: BUSINESS WEEK

uct announcements. The shares zoomed, allowing Parker to make a quick \$40,750. Inglis had advised Datastream when it incorporated in 1986. But both he and Parker deny they knew about the positive news in advance. “Seeing as how I had no idea who we were invested in, there was never any conflict of interest,” says Inglis.

Democratic pols can make money in the stock market, too. Representative Peter Deutsch (D-Fla.) entrusted \$600,000 in excess campaign cash to First Long Island Investors Inc., which

put the money into such large-caps as Johnson & Johnson, Intel, and Microsoft. It gained over 40%, or about \$240,000 over the 18 months ending last June. Deutsch didn't choose which shares to buy, but he received reports that listed each of the stocks and their performance. In July, he placed his funds with a less aggressive money manager that seeks to match rather than beat market indexes. Playing the market “has made my job easier,” says Deutsch. “I've spent less time fund-raising and more time being a congressman.”

BAD BETS. Not all pols have such luck. Campbell put \$200,000 into a global small-cap equity mutual fund managed by Robertson Stephens Investment Management. When he lost \$32,000 in nine months, Campbell moved most of his money to four other funds that invest in small and midsize companies

but they too lost value. In September, when he cashed out completely, his losses totaled \$63,000. Campbell, who represents Silicon Valley, says putting money into equities isn't a bad move but conceded his choice of funds was unwise. Seeking advice from an investment counselor “is one of the things I might consider next time,” he says.

Interestingly, the lawmakers willing to risk their hard-won campaign dollars were House members, who need ready access to their cash every two years. Senators face voters only once every six years. Yet they appear to be more financially conservative. Senator Kay Bailey Hutchison (R-Tex.) is typical. She is seeking reelection in 2000 and so far has invested \$4.2 million in Treasury notes with maturities of three to five years and interest rates averaging around 6%. “We're not in the business of making

vast amounts of money off of contributors, who expect [their money] to be used in her campaigns,” says campaign treasurer Kenneth W. Anderson Jr.

Like ordinary investors, lawmakers must choose investments that match their ability to stomach risk. But the downside can be greater than losing the nest egg—pols could alienate contributors. And those whose investments raise ethical questions risk losing the trust of voters—and possibly their jobs.

By Paula Dwyer and Amy Borrus in Washington



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COMMENTARY

By Lorraine Woellert

U.S. AIRLINES: MAKE SURE YOUR PARTNERS ARE SAFE

American carriers are rushing to go global—but not just by buying new jets and adding routes. Instead, they're teaming up with foreign carriers to create huge worldwide alliances that generate healthy profits at little extra cost.

United Airlines Inc. set the standard last year with its eight-airline Star Alliance. American Airlines Inc. followed suit last month in a deal with four foreign carriers called oneworld. Continental and Northwest are in talks with KLM, Air France, and Alitalia.

NO AUTHORITY. Travelers might cheer the convenience offered by such "code-sharing" deals, which allow them one ticket for a multicarrier itinerary. But regulators and watchdog groups are growing worried—as well they should. In the frenzy to get a foothold in emerging markets, many deals are pairing U.S. carriers to foreign airlines with sub-par or suspect safety records. Delta Air Lines, for example, teams up with AeroPeru. Continental's partners include Brazil's VASP. All have fatal accident rates 4 to 32 times higher than major U.S. carriers.

Delta is now negotiating with Aeroflot. And American passengers to Beijing could end up flying China Eastern, which has a fatal-accident rate almost 20 times higher than the average of the major U.S. carriers.

What can the FAA do? Not much. The U.S. Transportation Dept. has no authority to impose safety rules on foreign carriers unless they touch down on U.S. soil. But just because the government lacks authority to regulate code shares, U.S. airlines should insist that their partners adhere to the same safety standards required of them.

The DOT's top watchdog has the

same concern. Inspector General Kenneth M. Mead says he'll be looking into code-share pacts later this year. "I get multiple explanations [from the FAA] to what extent U.S. safety rules apply to foreign carriers," Mead told BUSINESS WEEK. "Doesn't the consumer have a reasonable expectation that the level of safety on that code-sharing partner

Alliances Galore

U.S. airlines are in a rush to form alliances with foreign carriers, some of which raise safety questions.

AMERICAN Partner with Central America's TACA Group, with members from countries that fail to meet global safety guidelines

DELTA Deal with AeroPeru, which has fatality rates that are significantly higher than Delta's

CONTINENTAL Allied with Aserca Airlines Venezuela, despite Venezuela's failing air-safety marks from the FAA

UNITED Partner Thai Airways has a fatal accident rate about eight times the rate of United

DATA: BUSINESS WEEK, AIRSAFE FINANCIAL CONSULTANTS

will be comparable?"

At least one airline may be getting the message. This summer, United reached an accord with its Star Alliance on safety standards. Among other things, it calls for internal safety audits and

protection for whistle-blowers who spot flaws. But even that small step was slow going. "One just doesn't leap out and take an 'ugly American' position and say, 'By the way, we're going to come audit you,'" says Edmund L. Soliday, United's head of corporate safety and security.

Other carriers say they'll carefully assess a foreign carrier's safety standards before considering an alliance.

But that's often as far as it goes. One executive at a major airline confides that his carrier won't perform safety audits on code-share partners because the company's lawyers fear legal exposure in the event its foreign partner has an accident.

FAA Administrator Jane F. Garvey wants the International Civil Aviation Organization, a U.N. group that monitors world aviation laws, to take the lead in policing safety for all carriers. That's well-intentioned, but ICAO isn't known for playing an aggressive role.

If U.S. airlines don't tackle this problem, they'll likely be forced to take direction from the courts. In the first suit arising

out of an international code-sharing deal, Delta Air Lines Inc. has been sued by several survivors of Delta ticket holders who were aboard Swissair 111, which crashed off the coast of Nova Scotia on Sept. 2. Although Swissair had one of the industry's best safety records, the suits allege Delta was responsible for its passengers' safety. Delta and Swissair say it's Swissair's problem. If the courts side with passengers in this case, imagine how vulnerable airlines will be if they hook up with a carrier with a poor safety record.

Here's some cheap legal advice: U.S. airlines shouldn't wait for the subpoenas. They should demand higher standards from partners in return for granting easy access to U.S. travelers. Safety should never take a backseat to profits.

Woellert covers aviation policy from Washington.



BIG DEAL:

United's alliance includes Thai Airways (right)



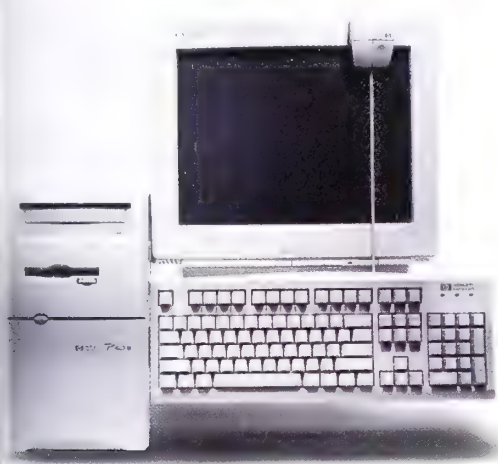
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LABOR RELATIONS

THE BALL'S IN HIS COURT

The NBA contract fight may hinge on an arbitrator's decision

As the official start of the season approaches, the National Basketball Assn. and its players are at a stand-off: The players refuse to sign a new collective bargaining agreement, and the NBA is locking them out until they do. On Oct. 5, the impasse led the NBA and Commissioner David Stern to cancel all its preseason games.

But fans shouldn't throw in the towel yet. By mid-October, an arbitrator will rule on whether owners must honor individual player contracts—and pay some of its priciest stars—during the lockout that began in July. Whichever side loses may be a lot more willing to compromise.

The stakes are high: At least \$720 million is owed on 220 contracts for the season that is set to begin on Nov. 3. If players lose, they would go without their multimillion-dollar paychecks for as long as the lockout lasts. If owners lose, they will have to shell out an amount equal to 70% of last year's total payroll. "It's a hell of a lot of money for (owners) to gamble if they lose the arbitration," says Jeffrey L. Kessler, the outside lawyer for the National Basketball Players Assn.

NO PRECEDENT. The central issue the arbitrator must decide is whether individual player contracts—multiyear pacts between free agents and teams—are part of the collective bargaining agreement, which expired on June 30 and is at the heart of the lockout. The agreement sets such rules as who can be a free agent and the cap on each team's payroll. The owners say the

free agent contracts couldn't exist without it. So no agreement, no contracts, no paychecks. "We're legally free to prevent players from working by locking them out, and when you're not working, you don't get paid," says NBA Chief Legal Officer Jeffrey A. Mishkin.

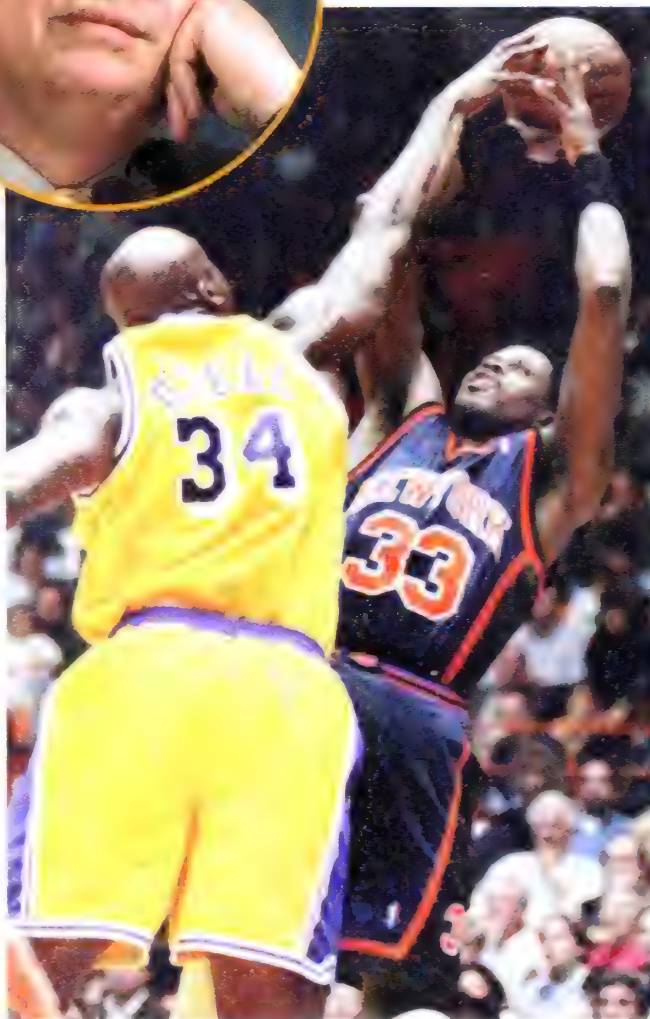
Not so, say the players, pointing out that when the agreement

expired in 1988, owners honored individual player contracts as the two sides continued to negotiate. And in a couple of cases, some prescient teams even went on to put clauses in player contracts specifying that players don't get paid during a work stoppage. Since teams failed to do so in the 220 contracts now in dispute, they're still in force, players say.

So who's right? That's unclear, since no precedent exists in federal labor law. "The relationship between individual and collective contracts has never really been addressed before," says William B. Gould IV, the former chairman of the National Labor Relations Board, which enforces federal labor law.

The arbitrator, John D. Feerick, Dean of Fordham University School of Law in New York, must rule by Oct. 18. After he does, the two sides will go back to the table on the collective bargaining

The NBA's Stern and the players are waiting to see if there will be a basketball season this year



agreement. The key issue remains the owners' demand to drop the so-called Larry Bird exception, which lets teams go over the salary cap to sign free agents. The clause has driven up total salaries to 57% of the NBA's \$1.76 billion revenue last season, above the current 51.8% cap.

But a huge new pot of money—\$2.65 billion from television contracts, a 14% increase—has both parties digging in their heels. Owners want to tighten the salary cap to make sure that they keep more of the new money. Players are just as eager to get their piece. Feerick must break the logjam if he comes down decisively for one side. But the parties must hurry and strike a deal if the season is to start on time. Otherwise, fans could end up feeling like baseball devotees did during the 1995 strike: angry that the ball's not being played, blaming both sides for a spoiled season.

By Aaron Bernstein
in Washington

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CARS

\$88,000 TOY: The 3200 GT coupe is Maserati's first new model in years

THOSE HIGH-END ITALIANS ARE REVVING UP AGAIN

Ferrari, Ducati, and other makes are pulling out of the pits

In their heyday, Italian sports cars were synonymous with record-breaking speed, elegant design, and astronomical price tags. Cutting-edge technology and racetrack glories put autos built by Maserati, Lamborghini, and Ferrari at the top of car lovers' wish lists around the world. These days, though, the names evoke more nostalgia than desire.

That may be about to change. Italian car- and motorcycle makers are betting they can resurrect celebrated brand names to gain an edge in the world's highly competitive luxury markets. Maserati and Lamborghini, as well as motorcycle companies Ducati Motor and Moto Guzzi, are unveiling new models, overhauling aging plants, and burnishing their images through merchandising and museums. "There's huge power in the brand name," says Salomon Smith Barney analyst John Lawson.

Lawson thinks many carmakers have neglected the luxury segment, which can be hugely profitable. Now, some of the industry's biggest names, such as Fiat and Volkswagen, are paying it more mind. With financial markets crashing around the world, their timing may seem off. But Italy's carmakers intend to sell just a handful of cars in

select markets. And companies such as Maserati and Lamborghini will benefit from their parents' distribution networks, management, and technology.

Italy already has one success story in this sector: Ferrari. Near bankruptcy after the death of founder Enzo Ferrari in 1988, the company got a fresh injection of capital from parent Fiat. After renewing its product range over six years, Ferrari posted consolidated sales of \$600 million in 1997 and pretax profits of \$22 million. In the U.S., its bread-and-butter market, an enlarged dealer network helped sell 3,581 cars last year. "These kinds of cars appeal to the superrich, who are not affected by general economic cycles," says Michael Smith, an analyst with Standard & Poor's DRI.

Now, Fiat wants the company to work the same magic on Maserati, also a subsidiary. Last year, Fiat sold a 50%

stake in Maserati to Ferrari. Since the Ferrari has poured \$15 million into revamping Maserati's factory in Modena. Another \$60 million went to developing Maserati's first new model in more than eight years. The two-door Maserati 3200 GT coupe will go on sale in January at \$88,000. With a turbocharged V8 engine and a choice of 14 designer colors, the GT is expected to push total sales to \$135 million in 1999, from an estimated \$55 million this year. Next, Maserati plans to introduce another model, the Spyder, in the U.S. before 2002.

A similar renaissance is under way in Bologna, where Lamborghini has found a German savior. Volkswagen's Audi luxury carmaking unit purchased Lamborghini in July for an estimated \$1 billion and already has new models in the pipeline. Thanks to cost-cutting, the company eked out a \$120,000 net profit in 1997—its first in years. Lamborghini's successful, eight-year-old Diablo, priced at \$250,000, is soon to be duplicated in a smaller version called the Baby Diablo that will cost about half as much.

ROYALTIES. Motorcycle makers are following the same strategy. After years of losses, Italy's 78-year-old motorbike company, Moto Guzzi, is seeking to revive itself. The company recently stalled a new CEO and management team and filed with the U.S. Securities & Exchange Commission to list on the NASDAQ market. The move would help finance improvements to its plant in central Italy and increase production threefold, to 20,000 units per year.

Meanwhile, Italy's second-largest motorcycle company, Ducati, may list on the Milan bourse and the New York Stock Exchange. After a reorganization two years ago, sales in 1997 climbed 88% from 1996, to \$230 million, as Ducati earned \$3 million. Now, it's opening outlets in the U.S., Europe, and Australia to sell biking gear. In October it will open a museum in Bologna, displaying 27 bikes from its collection.

In fact, merchandising is crucial to the brand-name revival. Ferrari makes \$11 million per year from merchandising and licensing royalties. Its Grand Prix T-shirts, watches, and hats are sold at Ferrari stores worldwide and at Formula One races. Similar plans are being developed for Maserati, which already offers a set of luggage that fits into the trunk of its new coupe. Maserati hopes that customers who can't afford the car may at least spring for the suitcase.

By Monica Lerner in Modena

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'THERE'S NO PLACE YOU CAN HIDE'

Even Wall Street's biggest firms are vulnerable

David H. Komansky, CEO of Merrill Lynch & Co., is a gregarious, even jolly man. Yet on Oct. 6, during the International Monetary Fund annual meeting in Washington, he was uncharacteristically grim. Referring to a sobering day of client meetings the day before, Komansky says, "the fear and depression are terrible."

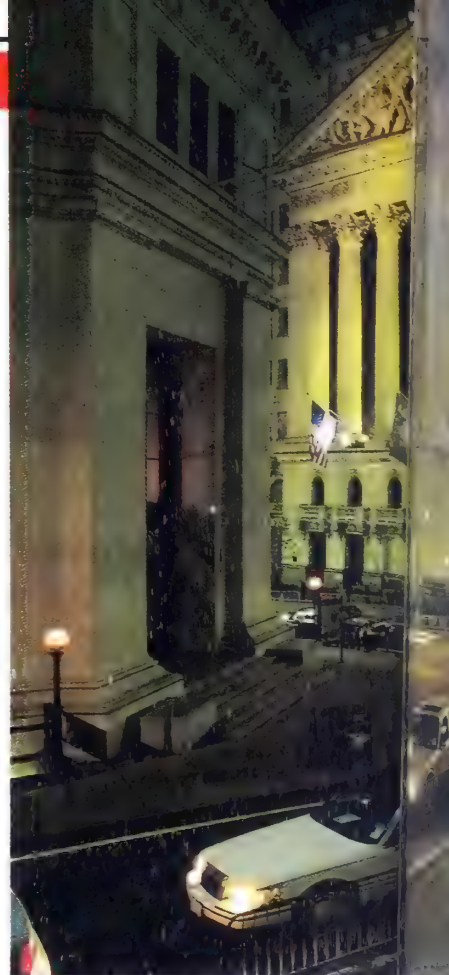
Komansky is not just feeling his clients' pain. He is deciding how much to shrink head count and capital committed to various world markets, in anticipation of a continued slowdown in underwriting and trading. When Merrill announces its third-quarter earnings on Oct. 13, it is expected to announce that 3,000 employees out of 60,000 will be pounding the pavement. J.P. Morgan and Citicorp are also planning 5% staff cuts.

GRAPHIC PROOF. The global contagion has hit Wall Street with a vengeance, and nobody is safe. On Oct. 7, spooked by Federal Reserve Chairman Alan Greenspan's dour comments, the ten largest money-center and investment banks all hit new lows in the stock market, with Lehman Brothers Inc. down 7%, Merrill down 6%, and Chase Manhattan Corp. down 5% from their 1998 highs. Commercial and investment bank-

ing analysts are slashing their estimates, and rating agencies are awash in downgrades for financial firms. The \$3.6 billion bailout of Long-Term Capital Management came too late to save the \$700 million in losses at giant Swiss bank UBS and alarmed Congress about financial institutions' exposure to hedge funds.

Wall Street, along with the commercial banks, is also facing a new threat: world disillusionment with unfettered capitalism. Will governments allow global capital markets to continue to operate freely? At the IMF conference, World Bank officials, finance ministers, and even hedge-fund billionaire George Soros called for capital controls and stricter regulations and disclosure for banks, brokers, and hedge-funds worldwide. This is bad news for the U.S. financial industry. "We're at a turning point for global capitalism," says Robert D. Hormats, vice-chairman of Goldman Sachs International. "If you inhibit capital flows in a serious way, emerging-market growth prospects diminish. That's bad for everyone, including Wall Street."

For the once mighty masters of the universe, the new environment is depressingly down-to-earth: a significant slowdown in their major businesses, fur-



ther losses, shrinking balance sheets, shriveled bonuses, layoffs, greater regulation, and consolidation. "It will be a period of lower earnings with probable some cutbacks of personnel and rationalization of business strategies," says Jerome P. Kenney, executive vice-president at Merrill. On Oct. 6, Merrill's brokerage analyst even recommended dumping certain brokerage stocks.

Commercial banks have been feeling pain for months, and there seems to be no letup. J.P. Morgan and Bankers Trust are the money center banks that are expected to fare the worst, says CIBC's penheimer analyst Steven Eisman. Not only do they have major investments in emerging markets, but they are dependent on proprietary trading for some 30% of their bottom line. "Today, the trades are producing losses," says Eisman. The consensus forecast for Bankers Trust is a \$350 million third-quarter loss. Even though that's less than 3% of its \$11 billion capital base, its stock hit a low last spring, and is now around \$10. "There's no place you can hide from this global crisis," says Nancy Bush, a senior analyst for Ryan Beck & Co. "In 1980, we understood that the problems in the banking sector were commercial real estate. But this—this is much less defensible. We may enter a period where banks decide to circle the wagons."



WALL STREETERS IN WASHINGTON: Merrill's CEO at the IMF conference



WALL STREET: NO DOOM, BUT LOTS OF GLOOM

- ▶ Any retooling of the global financial system limiting the free flow of capital could hurt Wall Street because raising money for emerging-market companies and countries would be much harder
- ▶ Under increased scrutiny from regulators, investment banks may have to reduce their exposure to hedge funds, some of their biggest clients
- ▶ The flight to quality has especially hurt firms such as Lehman Brothers and Bankers Trust because investors would rather own bigger, more diversified financial institutions
- ▶ In response to market turmoil, Wall Street firms are shrinking their balance sheets, which will reduce their ROEs and earnings
- ▶ Financial firms will see layoffs owing to a slowdown in many businesses, including underwriting and trading in emerging-market securities, junk bonds, IPOs, and commercial mortgage-backed securities

DATA BUSINESS WEEK

The current flight to quality is hurting weaker, less diversified players, as Bankers Trust's stock slump shows. "1998 tough year, and 1999 will potentially be rough," says Charles G. Ward III, managing director, Credit Suisse First Mon. "But the strong firms will be fine. The weaker firms will be pushed out." Historically, this means the foreign firms that piled in late, such as second-tier French and German banks.

RUMORS, RUMORS. Market confidence is shaky, since financial firms are highly leveraged institutions that fund themselves by rolling over short-term commercial paper. Witness the recent rumors of Lehman. The firm has been hit by rumors, most of which appear false: that it sustained huge losses on a satellite it owned blew up; that it had \$5 billion of LTCM related losses; that it had been pressuring BankAmerica to acquire Lehman. Says Richard Fuld, the chairman of the New York Stock Exchange: "They've gotten caught in a lot of rumors and innuendo, none of which is true."

But in an extremely nervous market, the perception of a problem can be as damning as the real thing. Analysts are worried that Lehman is too dependent on bond trading and not diversified into more stable areas such as asset management.

The immediate issue for Lehman and others is, are investors still willing to own its debt? Already, Lehman is paying top dollar to raise money: Its one-year debt is selling at about 3.65 percentage points above the London Interbank Offered Rate, vs. 1% above LIBOR earlier this year. Lehman has equity capital of \$5.3 billion that supports a \$134 billion balance sheet, a typical degree of leverage. Its total long-term debt and equity is \$34 billion. But it has \$7.7 billion in commercial paper outstanding with an average maturity of more than 100 days that has to be constantly rolled over.

Lehman chief executive Richard S. Fuld says Lehman is in good shape to weather the storm. It's still selling its short-term paper, and it has almost doubled its long-term capital in the past two years. "The marketplace is beginning to realize that all of these rumors are totally bogus. The firm is strong and stable, and the market is realizing that," says Fuld.

Even the strongest firms hunker down in times of high risk and volatility by reducing assets. That by definition reduces earnings and return on equity. The best brokerage firms have posted ROEs for the past four years of 25% to 30%. Now, they will be lucky to get ROEs of 15%. "Financial firms are shrinking their balance sheets," says Sanford C. Bern-

stein analyst Sallie L. Krawcheck. "If they don't have the big balance sheets, they can't earn the same returns."

U.S. financial institutions may also be headed into a more unforgiving regulatory environment. Arthur Levitt Jr., the Securities & Exchange Commission chairman, is under congressional pressure to beef up the SEC's scrutiny of securities firms. This could lead to ongoing examinations of the firms' books and records to gauge their exposure to hedge funds.

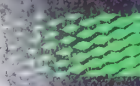
There are a few bright spots. Lower-priced companies mean potential bargains for leveraged buyout firms, which have about \$100 billion ready to spend. Apply a modest amount of leverage, and that's \$400 billion of spending power. LBO firms may even get financing in the middle of a credit crunch, thanks to a resurgence in mezzanine lending, which is privately placed subordinated debt that will finance LBOs, says CSFB's Ward.

But that is little consolation to owners of financial-services stocks. With all the recent wealth destruction, many bankers have been personally pounded. For example, as much as half of the 1997 bonuses of top Merrill Lynch bankers were paid in Merrill stock, which has cratered from 109 to 37%. In a word: Ouch!

By Leah Nathans Spiro, with Dean Foust, in Washington

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INTERSPOUSAL TRANSFER GRANT DEED

(Excluded from reappraisal under California Constitution Article 13A § 1 et seq.)

Dated 8-27-98

STATE OF CALIFORNIA CT
COUNTY OF Fairfield

On August 27, 1998

the undersigned

personally appeared

John Meriwether

before me,

John Meriwether

VALUABLE LOT: John Meriwether signed over this 20-acre Pebble Beach (Calif.) lot to his wife on Aug. 27

LTCM spokesman Peter Rosenthal. "The implementation was begun, of this particular thing [the property transfer], a number of months earlier," he said. Why would it take "a number of months" to obtain Meriwether's signature on the bottom line of a simple, two-page property-transfer form? Said Rosenthal: "You got to get somebody to do it, you know, and he has other things to do every day."

Whatever the motivation, the effect of the transfer was to get the property out of reach of future creditors. The lot was transferred to Meriwether's wife as "her sole and separate property." Lawyers say that means creditors may be hard-pressed to seize that valuable property, even though California's community-property laws generally mean property owned by one spouse is the property of the other spouse.

To be sure, there has been no litigation. And Rosenthal insists the timing should in no way arouse suspicion, even though Meriwether acted at the tail end of the month that almost put LTCM out of commission. Still, the public record shows that if a lawsuit barrage begins, Meriwether will be ready.

LTCM itself was structured so that Meriwether and the other 15 principals have no liability beyond their own investment in the funds. Meriwether's colleagues, who include such top brains in finance as Nobel Laureate Myron S. Scholes and former Federal Reserve Vice-Chairman David W. Mullins, have been widely described in the press as the "general partners" of LTCM. But, in a strictly legal sense, they are not.

According to public records, the LTCM is a Delaware limited partnership owned by another limited partnership called Long-Term Capital Holdings. Corporate filings show that the general partner of Long-Term Capital Holdings is yet another corporate entity, LTCM LLC. And a person familiar with LTCM says that LTCM LLC is, in turn, owned by the 16 principals—though not always in their

EDGE FUNDS

MERIWETHER'S CURIOUS DEED

He transferred property to his wife during LTCM's fall

By all accounts, the last few days of August were hellish ones for John W. Meriwether and his beleaguered hedge fund, Long-Term Capital Management. In the midst of marketplace slaughter that sent—and its creditors—to the brink of catastrophe, Meriwether still had time to tend to some family business. On Aug. 27, he signed an "interspousal transfer grant deed" transferring to his wife, Mimi, a 20-acre vacant lot on Del Mar Road in a tony residential area of Pebble Beach, Calif. It was, until that point, the only property in his name. Was John Meriwether seeking to improperly put a major personal asset out of reach of potential creditors—such as hedge-fund investors—who might sue him for LTCM as a result of the firm's fall? What transaction and others years ago, did he effectively insulate himself from LTCM honchos from the consequences of their high-stakes bets?

These are troubling questions in light of the near failure of LTCM and the widely criticized \$3.6 billion bailout. Lately, attention has focused on four LTCM principals who borrowed money to finance their investments in the fund. Yet another issue remains unanswered—what is the personal exposure of Meriwether and his 15 colleagues? Though the bailout left them with vast, as yet undisclosed personal losses and a 10% stake in the firm, their personal liability has been kept to a minimum. A BUSINESS WEEK examination of public records shows that, long before the Aug. 27 transfer, Meriwether had shielded his own and his partners' personal assets in the event LTCM ever got into trouble.

VIGOROUS DENIAL. A Meriwether spokesman vigorously denied the Aug. 27 property transfer was for asset-protection reasons. "That was done in implementation of estate planning that was under way for over a year," said

own names. Some, he said, participate via their spouses and trusts.

Such complex corporate structures limiting top management's liability are a comparatively recent phenomenon among hedge funds, which were originally organized to give general partners personal liability if the funds went under. Still, hedge-fund lawyers note that such corporate structures often fail to shield managers when their investment vehicles run off the road.

CASH PURCHASE. But if LTCM's woes result in litigation, Meriwether has a second line of asset defense. While he may well have substantial liquid assets, he has none of the real property that creditors can easily track down and seize.

True, Meriwether lives on a widely publicized 68-acre estate in North Salem, N. Y. But land records show that it's not John Meriwether's estate at all, but rather Mimi Meriwether's estate. It was purchased for \$2.7 million, apparently in cash, in January, 1994, just as LTCM was getting ready to open for business. The estate was purchased by his wife, and there is nothing in the public record to indicate whether John Meriwether was the source of the funds.

The Aug. 27 transfer may be problematic because it took place at a time when the fund was in hot water. Estate and asset-protection lawyers say it could well be construed in any future litigation as a fraudulent act intended to hinder creditors—which, they note, is a misdemeanor under California law. "It smacks of a fraudulent conveyance," observes L. David Burningham, a California attorney who specializes in estate planning and asset protection. But Burningham adds that he does not know the circumstances of the transfer, which would be justified if it serves a legitimate purpose, as Rosenthal insists.

If Meriwether's actions have shielded his assets, the same can't be said for all of his 15 other "partners." Some have substantial assets in their own names that could be reached by creditors in any future lawsuits. One who didn't appear to anticipate anything amiss at LTCM was Scholes, who purchased a \$6.5 million house in San Francisco only this past July, on the brink of the LTCM disaster. Lawyers say that Scholes could have done a lot better job of structuring that purchase to protect that asset. Whatever his brilliance as an economist, Scholes may have a thing or two to learn about the finer points of asset protection. And John Meriwether would be an apt teacher.

By Gary Weiss, with Barbara Silverbush and Karen Stevens, in New York

MARKETS

TECHNICIANS TAKE CENTER STAGE

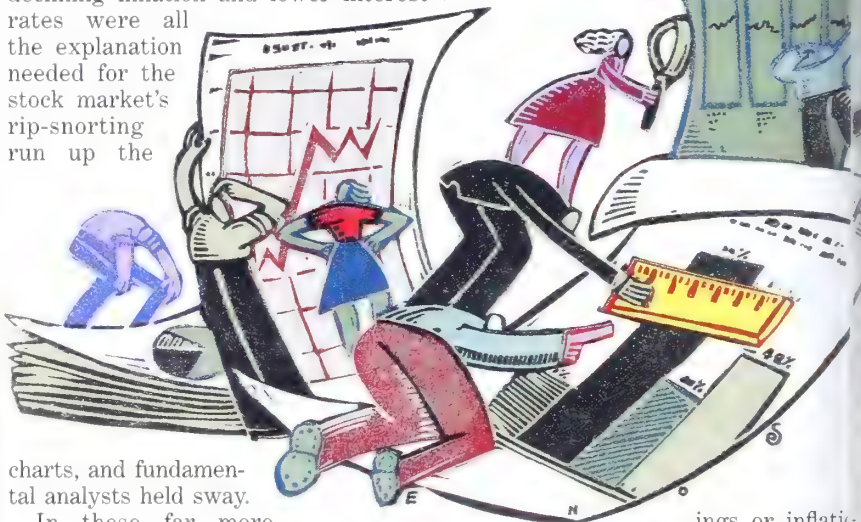
As investors look for answers, tech analysis grabs attention

Ralph J. Acampora is a man with a mission. As Prudential Securities' chief technical analyst and someone who has spent more than 30 years poring over charts to spot trends in the movement of stock prices, Acampora is a vocal champion of a field that, over the years, has been scoffed at by academics who disagree with its basic tenet—that studying past patterns of trading volume and price reveals supply and demand trends that can be regularly exploited. In any case, for much of the 1990s, solid fundamentals such as declining inflation and lower interest rates were all the explanation needed for the stock market's rip-snorting run up the

Also helping the reputation of technical analysis is that some recent calls, such as Acampora's on Aug. 4 for a big decline, have been on the money.

What do the technicians think will happen now? In the short term, some prominent techies think the market will fall further. The good news, they say, is a prelude to another leg of the long bull market—though no one is willing to pinpoint when that will begin.

Unlike fundamental analysts, technicians don't obsess over earnings



charts, and fundamental analysts held sway.

In these far more volatile times, however, with the long-term outlook so murky, Acampora and his ilk are getting more respect. "In times of market turmoil and extreme volatility, technical analysis can be more helpful, because fundamental analysis, in the short term, doesn't particularly help you," says Robert Doll Sr., executive vice-president of equities for Oppenheimer Funds Inc. "I've owned stocks where earnings are coming through, everything seems in place, but the stock kept going down. The market is telling you that something is happening that you haven't incorporated into your analysis, and sometimes you can't figure it out until it's too late."

ings or inflationary pressures. They examine price patterns of stocks and stock indexes to see whether the internal dynamics appear healthy according to, say, the way the stock has behaved over the past 20 trading days, or if a pattern seems to be unraveling. Increasingly, technical analysis is becoming intertwined with the increasingly popular field of behavioral finance, or the study of investment psychology, says Paul F. Desmond of the Market Technicians Assn. (MTA). "We're using technical indicators to measure the emotion of investors."

Salomon Smith Barney's Alan Shaw is the dean of the market technicians. Shaw, who sits on the firm's

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Prominent trend-spotters think a short-term market fall will be a prelude to another leg of the long bull market

vestment policy committee, enjoys an unusual position among his peers. While some Wall Street firms don't have an appointed technical analyst, "at Salomon Smith Barney, the technical discipline is integrated and coordinated on a policy level with the same weight and voice that the fundamentalists and economists may bring to the table," says Shaw. His motto: The trend is your friend. He believes that focusing on fundamentals caused many people to flee the market thousands of points ago. "My discipline has nothing to do with value," he says. "As a result, we've been permitted to take part in a great deal of the upside" in the long bull market, rather than bailing out because some fundamental analysis pointed to overvaluation.

Shaw expects the stock market to consolidate between 7500 and 8000. In fact, he gives that a 45% probability. Next, at 25%, is a market falling to 7000. The least likely move, at 5%: a race to 10,000 or higher within six months. Shaw thinks the market needs time to repair the damage done before it can move much higher. All in all, he gives it a 70% chance of trading flat to moving lower over the next six months.

Shaw keeps fairly aloof from the media, but one of his protégés, Prudential's Acampora, seeks the limelight. The title of an upcoming Acampora speech: "The Market, the Media, & Me." The telegenic analyst is a regular panelist on *Wall Street Week with Louis Rukeyser*. It was on CNBC, however,

that he made his biggest splash. On Aug. 4, Acampora, who had been calling for Dow 10,000, said the Dow could fall 20% from its high. By day's end, the market was down 300 points and is now down about 746 points from Aug. 4. Says Acampora: "It was a painful call, but in hindsight—what a beautiful call!"

LEG ROOM. Acampora's view today is that the market might bottom out at around Dow 7400. He will not speculate about what happens if the Dow goes below that. His favorite sectors: drugs, biotech, electric utilities, and tobacco.

One technical analyst who thinks a market bottom is still a ways off is Richard McCabe of Merrill Lynch & Co. "Early next year, the focus will be more and more bearish," he says. "That will be the bottom and the foundation for the next leg up to start in 1999 or 2000." Like Acampora, McCabe thinks we are seeing a cyclical bear market within a secular bull market. His view of the next upswing: "Even greater public enthusiasm, where the public says they're not happy with the 20% to 25% gains they made in 1996 and 1997—they want to double their money in six months." He thinks small-cap, and even speculative issues, could lead the market up in the next leg.

Most professional investors use both fundamental and technical analysis. Kenneth G. Heebner, a portfolio manager at Capital Growth Management, says technical indicators

can be helpful when they give extreme negative readings. If the put/call ratio (table) showed strong negative sentiment, "I might wait to sell something and see if the market would bounce." Martin G. Hurwitz, a senior portfolio manager at American Express Financial Advisors, uses technical analysis to spot groups seeing more "accumulation" (where investors appear to be buying the stock and putting it away) and may outperform in the short term. They include supermarkets, food and health care distributors, and gold.

Many academics maintain that technical analysis is of little use. Burton Malkiel is an economist at Princeton University and author of the influential book *A Random Walk Down Wall Street*. The random-walk theory posits that past price moves aren't useful in forecasting future price moves. Malkiel says he understands why techies are in the news: "It's so natural at times like this that you search for ways you might have avoided the unpleasantness," he says. "I agree, the market is not a perfect random walk. But whatever regularities there are are very small and very undependable from period to period."

Perhaps the increased interest in technical analysis will prove to be a short-lived trend. But a lot more people are being

exposed to

its rigor

"Within the

last year

technical

analysis, be-

none, is the

hottest-selling

course here, out-

160 offerings," says

Chris Genera of the New

York Institute of Finance

Academy is taking more notice

too: The Market Technicians Association

recently held preliminary talks

with the University of Pennsylvania's

Wharton School about doing

conferences and studies to-

gether, says the MTA's Desmond

With investors awash in a sea

of uncertainty, looking for an edge

via technical analysis is seductive

"In price there is knowledge," insist

the technicians. From that

knowledge, they and their prop-

onents hope, come profits.

By Suzanne Woolf

in New York

CHECKING THE CHARTS

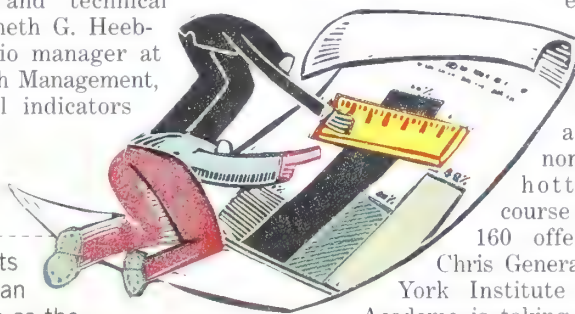
How the pros try to divine the markets:

MOVING AVERAGES To figure out when to get in and out of the market and spot turning points, technicians use "moving average lines." To calculate one, they add up the closing price of a stock or index for a number of trading days, such as 200, then divide that by 200. Daily plotting reveals the trend. A popular moving average: the advance/decline line, which graphs the difference between the number of rising and falling New York Stock Exchange issues.

PUT/CALL RATIO When the put/call ratio gets to an extreme, it can be a contrary indicator. The ratio is the vol-

ume of puts (bets that an index such as the Standard & Poor's 500-stock index will fall) vs. the volume of calls (betting that the index will rise) purchased on the Chicago Board of Exchange.

SENTIMENT INDICATORS Another contrary indicator comes from *Investor's Intelligence* sentiment figures. It looks at 150 investment advisory newsletters to determine the bearish or bullish nature of the newsletters. If a historically high percentage of the market letters—say, 55%—are bearish, that could indicate that the market is bottoming.



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MUTUAL FUNDS

A BATTLE INVESTORS CAN'T WIN

Donald Yacktmán and his board are trying to oust each other

Donald A. Yacktmán, a well-regarded mutual-fund manager in Chicago, is in an awkward position. As he sees it, the directors of the funds he founded are trying to throw him out, so he has launched a preemptive strike to oust those directors and replace them with a friendlier bunch. A special shareholder meeting is set for Nov. 24.

The very unusual battle centers mainly around investment performance—which has not been good of late—and what to do about it. So far this year, the Yacktmán Fund is down 15.8%, vs. a 2.6% gain for the Standard & Poor's 500-stock index (including dividends). Yacktmán says the directors have been pressuring him to convert to a large-cap value portfolio—funds typically heavy on manufacturing, energy, and utility stocks.

Yacktmán's investment strategy defies such conventions. His modus operandi is to buy growth stocks when they are out of favor. The prospectus says the investments must be "primarily" in stocks with \$1 billion or more market cap. Morningstar Inc. says the Yacktmán Fund has a \$1.4 billion median market cap. "This is how I've always invested," says Yacktmán. "My shareholders get the same Don Yacktmán yesterday, today, and forever."

He concedes his results always have been cyclical—and they're in a down cycle. With such strategies, the payoff comes only if the periods of strong performance more than compensate for the weak. Yacktmán usually does well in risk-adjusted fund ratings, since he often takes lower than average risk. Now, the Yacktmán Fund has four stars from Morningstar, the second-



ON THE ATTACK: Yacktmán gears up for a proxy fight

highest rating, and B+ from BUSINESS WEEK, our second-highest as well.

But with lousy recent returns, shareholders have been leaving in droves. The Yacktmán Fund is only about half the size it was a year ago. Still, anyone remaining by the time of the Nov. 24 shareholder meeting is probably a Yacktmán loyalist, which suggests the prospects for him prevailing in a proxy fight are good. He's spending Yacktmán Asset Management Co.'s money to wage it.

The independent directors are in an unusual spot as well. As of Oct. 6, they had not yet filed their response to Yacktmán's proxy but are expected to do so shortly. But as repre-

sentatives of the shareholders, they be spending fund assets to advocate position that most remaining shareholders likely will reject.

This battle can be costly for shareholders. Last year, the independent directors of the Navellier Aggressive Small Cap Equity Fund dropped manager Louis G. Navellier and moved the fund to Massachusetts Financial Services. Three months later, the shareholders voted to rehire Navellier. In the

scuffle, the portfolio turned over several times, resulting in high trading costs and capital-gain distributions for investors.

FORMER FRIENDS. Ironically, the directors Yacktmán is seeking to oust were once his friends, as "dependent" directors usually are. All have been on the board since the fund's founding in 1992. Director Jon D. Carlson says he and Stanislaw Maliszewski worked with Yacktmán at his previous job. Carlson says he and Stephen E. Upton, his uncle by marriage, and Thomas R. Hanson, were longtime shareholders of Yacktmán's prior fund, Select American Shares.

Until June, Carlson was Yacktmán's marketing chief and then an inside director. But he became an outside director when Yacktmán dismissed him. Yacktmán says directors turned against him when he fired Carlson. Carlson says the board had differences with Yacktmán long before the proxy fight, which he tried to get resolved.

Besides performance, the directors also complain about "derivatives" and "ethics." Yacktmán says his own derivatives are put options on the largest holding—Philip Morris Cos., and those are in the \$52 million Yacktmán Focused Fund, whose prospectus permits it. Ethics? The Yacktmán Fund code says personnel shouldn't sit on boards of public companies without directors' permission. Yacktmán remains on the board of a private company, 800-Contacts Inc., after it became public but he says the fund directors knew Yacktmán says he has since asked 800-Contacts to replace him. Moreover, he says his funds are not and never have been investors in that company.

No doubt, the charges and countercharges will continue. But what would benefit investors more than a costly proxy fight would be for the warring parties to work out differences and improve performance of the funds.

By Jeffrey M. Laderman in New York

YACKTMÁN FUND: A SNAPSHOT

Assets: \$511.7 million

TOTAL RETURN*

1998	-15.8%
PAST 12 MOS.	-15.7
PAST 3 YRS.	10.8
PAST 5 YRS.	14.7

*Appreciation plus reinvestment of dividends and capital gains before taxes. All periods through Sept. 30, except 1998 return through Oct. 6. Multiyear returns are average annual

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BREAKING THE PLASTIC MOLD.™

BY GENE G. MARCIAL

THESE STOCKS MAY JUST DEFY GRAVITY

"This market is wild," says investment manager Rob Lyon as he peered into his computer screen on Oct. 6. The Dow Jones industrial average swung like a pendulum from a 140-



VALUE PLAY: Lyon bailed out of techs

point gain in the morning to a loss of 60 by afternoon and back up with a gain of just 16 to close at 7742. Fortunately for large-cap value investor Lyon, he repositioned his core holdings last spring and summer: He sold technology, basic-industry, and capital-goods stocks, and bought into shares in the consumer-products, health, and telecom sectors.

Among his top choices: tobacco giant Philip Morris (MO), drugmaker Bristol-Myers Squibb (BMY), and telecom leader Bell Atlantic (BEL).

"We think Asia won't come back for some time, and neither will Japan and Russia," says Lyon, president and chief investment officer at Institutional Capital in Chicago, which manages some \$11 billion. The result, he says, will be a slowdown in global growth. Capital spending will be crimped, Lyon figures, and technology will be hurt.

Philip Morris has been a marvel, says Lyon: "It kept going up as the market was slumping." After hitting a low of 34 in mid-May, the stock stuck to an upward trend, closing at 49% on Oct. 6. Lyon sees it heading for 65 over the next 12 months. "Morris has been winning court battles," he notes. Talks with eight U.S. states to settle lawsuits against the tobacco industry are making progress, Lyon adds. One added kicker: Management is now open to the idea of spinning off its Kraft Foods unit, which is the largest packaged-food company in North America and which Lyons values at \$40 billion, or 25 a share. The tobacco business alone, he figures, is worth \$90 billion, or 40 a share.

Bristol-Myers, now at 97, is an un-

dervalued drugmaker with a large product pipeline that investors have yet to recognize, says Lyon. His target for the stock: 130. Bell Atlantic has also been bucking the market, rising through some dips, from 41 in mid-August to 52 by Oct. 6. With its merger with GTE, Bell Atlantic is poised to enter the long-distance market, says Lyon, who figures the stock is worth 65.

IS IMCLONE STILL INCLINED TO DEAL?

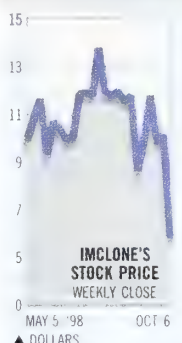
For weeks during the summer, shares of ImClone Systems (IMCL) had been hovering between 12 and 14, not only because the company has developed exciting anticancer products but because of rumors that a pact with a strategic partner was imminent. By late September, the hot money in the stock became impatient and bailed out. Result: ImClone plummeted, closing at a 1998 low of 5 1/2% on Oct. 6. Not so fast, says biotech maven Jim McCamant, editor of the *Medical Technology Stock Letter* in Berkeley, Calif. McCamant believes that a deal is in the works involving a European pharmaceutical company.

McCamant, who thinks signing up a European partner is near, says this new partner will either take a significant equity stake in ImClone or license ImClone's lead compound, C225, now in Phase 3 clinical trials to treat head and neck cancer, such as mouth or throat cancer. ImClone is also conducting trials for C225 as a therapy for renal cell cancer.

Another ImClone compound, BEC², is a cancer vaccine that is being developed in collaboration with German drugmaker Merck KGaA (no relation to Merck & Co.). Also being developed are compounds to treat angiogenesis, which is the formation of new capillary blood vessels associated with tumors.

"ImClone's current market cap is unjustifiably low," says McCamant, who expects the stock to double once a partner is announced.

HANGING ON A EUROPEAN PACT



DATA: BLOOMBERG FINANCIAL MARKETS

STERICYCLE: A CLEAN PLAY

This is not the time to give up on mid-cap growth stocks, says investment pro Andrew Lanyi, who calls the group's severe pounding a rare buying opportunity. Scores of mid-cap stocks have plunged although their profits and sales stayed at high levels in the past four quarters, says Lanyi, head of Lanyi Research, a unit of CIBC Oppenheimer in New York. "We've been heavy buyers of mid-cap growth stocks with quality earnings," he adds.

Among his top picks: Stericycle (SRCL), the second-largest U.S. provider of regulated medical waste-management services. Stericycle's patented electro-thermal deactivation destroys bacteria without producing air pollutants. Now at 18, the stock is worth 30, says Lanyi, based on the company's growth through acquisitions.

He expects profits to jump 269% this year, to 48¢ a share, from last year's 13¢, and by 85% next year, to 89¢. Revenues should swell to \$64 million this year and to \$85 million in 1999, up from \$46.2 million in 1997.

Stericycle has bought 11 companies with about \$30 million in total revenues this year. By the end of the first quarter, Stericycle CEO Mark Miller had signed confidentiality pacts with companies with total revenues of \$80 million in the hope of completing more acquisitions, says Lanyi.

Stericycle, which is in 43 states and Canada, Mexico, and Brazil, has only 7% of the \$1 billion medical-waste management industry, says Miller. "Our goal behind our acquisitions is to become No. 1," he says, acknowledging he is in talks with a number of companies for more buyouts. Leader Brown-Ferris has 19% of the medical-waste market, with revenues of more than \$200 million from that business.



A BUYER: Lanyi loves growth

BusinessWeek ONLINE

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A black and white photograph of a person's hand holding a VHS tape. The tape is labeled 'ROCKY' in large, bold letters. To the left of the tape, the text '@yo' is displayed, with the '@' symbol in red and 'yo' in white. The background is blurred, showing what appears to be a window or a doorway.

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A CYBER REVOLT IN HEALTH CARE

Patients are finding new power through the Web

When 55-year-old Melinda Brown was told a year ago she had colon cancer that had spread to her liver and was inoperable, her daughter Jeanette reacted by going to the Internet. Jeanette wasn't looking for support groups. Instead she was hunting for cold, hard facts about the disease and treatment. During her lunch hour, Jeanette mouse-clicked her way across sites and read through thousands of entries served up by search engines when she typed in the word "cancer."

After a week of searching, she hit promising news—someone who survived a situation similar to her mother's through a new type of surgery, called cryosurgery, that uses nitroglycerin to freeze cancerous tumors. Jeanette's doctor hadn't heard of the treatment, so the Washington (D.C.) family found a specialist. After two rounds of surgery, the tumor appears to be in remission. "The Net has so much more information than any one physician could ever know," says Jeanette, who is now in graduate school at New York University.

UNVARNISHED FACTS. There's a grass-roots movement sweeping across the Web that could radically change the doctor-patient relationship. Patients finally are getting their hands on information that doctors didn't know about or simply wouldn't hand over in the past. And just as information and services on the Net have freed consumers from annoying haggling with car salesmen, it's giving patients unvarnished facts about their diseases. Armed with data they've found online in medical journals, databases, and consumer health sites, patients are walking into doctors' offices and asking about treatments and diseases some physicians may never have heard of or considered. "It's a fundamental shift of knowledge, and therefore power, from physicians to patients," says Jim Hudak, global managing partner for health at Andersen Consulting.

That newfound power puts health care on track to be the next big thing on the Net. Already, more than 17 million people

in the U.S. have looked up medical care data online this year; up 35% from 1997, according to researcher Find/SVP. More broadly, a recent Intelliquest Inc. survey found that 30.8 million people, or 46% of online users, looked up information about a medical or personal problem.

Those numbers haven't gone unnoticed. Almost overnight, companies large and small are bolstering or launching services for consumers—providing personalized news, risk assessment ser-

"It's a fundamental shift of knowledge ... from physicians to patients," says one consultant

vices, insurance, and online drug-stores. Since 1997, nearly \$120 million in venture-capital funding has been sunk into Internet-related health-care companies, says researcher VentureOne Corp. And on Oct. 27, Intel Corp. will hold a Health Technology Day to raise the market's profile and unveil investments and partnerships the semiconductor giant is weaving together to speed adoption of online health care. For Intel, more consumers looking up information online means more computers—and chips—sold. "Health care isn't the primary reason people get online, but that will change," predicts Steven McGeady, director of Intel's Health Technology Initiative.

The Net may usher in an even more profound change. For years, there has been a push to bring health care into the computer age, giving patients more access to data and improving and tracking treatment. Until now, the health-care system has resisted—doctors' offices are the last great bastions of

notepads and paper files. But the rippling effect of consumers using the Net could convert even the Luddites. "It's quite a challenge to introduce change but we're doing it," says Anna-Lisa Svestra, general manager of Kaiser Permanente's national member technology group. "The main reason is our customers are asking for it."

Kaiser, like some health maintenance organizations, is dishing up promised services on the Web that move well beyond just offering electronic brochures about benefits. During the next months, Kaiser, the largest nonpro-





THE HEALTH NET

EMPOWER HEALTH'S DR. KOOP

Launched in July by former U.S. Surgeon General Dr. C. Everett Koop, the site offers medical data, chats, an online pharmacy, and health-site reviews, and drew 400,000 visitors in September.

HEALTHFINDER A Web site developed by the U.S.

Health & Human Services Dept., it provides basic definitions of conditions and links to government consumer health and human services data, agencies, not-for-profit organizations, selected online publications, and medical dictionaries.

BETTERHEALTH Owned by popular women's site iVillage.com, it offers lay explanations of conditions, chats with physicians, links to government and health associations, and a personalized Web page that includes a risk assessment on your health issues and customized news.

WEBMD Launched Oct. 5 for doctors seeking medical data, insurance services, an answering service, and Internet access for \$25 to \$175 a month. Transaction processor Envoy Corp. will provide Internet access, WebMD's content, and transaction services to 60,000 Aetna physicians, while health software giant HBO & Co. invested \$10 million and offers the service to hospitals.

online chats with physicians and nurses, personal medical pages with news alerts and customized data, and risk-assessment services that rate a person's health based on lifestyle and medical history—with information on how to improve it. Sites also are piling on to the E-commerce bandwagon, selling products that range from vitamins to health insurance. **"CYBERQUACKS."** For all that, dispensing health care on the Net is not without its drawbacks. For one, many Web surfers worry about privacy when it comes to coughing up personal medical data. But the biggest obstacle could be the large amount of bad information. With an estimated 15,000 health sites, the amount of data that is just plain wrong or misleading hurts the credibility of the Web. So far, there have been piecemeal attempts to fix this, such as the one by the nonprofit Health on the Net Foundation that certifies and monitors sites. On Oct. 14, the Health & Human Services Dept. will launch a site (www.scipich.org) aimed at teaching consumers how to evaluate sites. "The opportunity for cyberquacks is out there," says Andersen's Hudak.

Longer term, the hope is the Web will go far beyond serving up medical data and will finally link together physicians, patients, and insurers like a massive electronic nervous system. The benefits are hard to ignore. About a third of the \$1 trillion spent on health care in the U.S. is wasted on unnecessary and duplicated treatments, estimates Andersen. But connecting the different systems and offering electronic medical records has stalled, in part, because of how fragmented the health-care market is and the hodgepodge of computer systems used. Privacy concerns are another hindrance, since a problem with linking networks is ensuring the confidentiality of information, such as HIV-test results.

Headway is being made. Leading makers of technology for the health-care industry—such as Shared Medical Systems, HBO & Co., and IDX Systems—are creating Web versions of their products. "Our customers are pushing us very hard," says Mark Wheeler, chief technical architect at IDX.

Clearly, consumers are being heard. Startups already are stepping into the void left by hospitals and doctors who shun the Web. Dr. Koop and Seattle-based startup Lexant, for example, plan to offer personal health-care records that let consumers fill in their medical histories and, when possible, link electronically with labs or doctors' offices to add data about recent tests or visits. Con-

with 9.2 million patients, is rolling Web site that will let members register for office visits and send e-mail questions to nurses and pharmacists (and get responses within 24 hours). Next year, the HMO plans to test e-visits to lab results and pharmaceutical orders online. Kaiser isn't the only one offering an online pharmacy. Established HMOs such as Merck Medco and start-ups such as PlantRx also aim to be the top drugstore (page 156).

While Kaiser is on the cutting edge, other HMOs haven't moved as fast, and some cybernauts are instead turning to consumer health sites. Topping the

list are Mayo Clinic Health Oasis, BetterHealth, run by popular women's site iVillage.com, and DrKoop.com, a service launched in July and backed by former U.S. Surgeon General Dr. C. Everett Koop. The latter boasted 400,000 different visitors in September, while year-old Betterhealth drew 650,000 in August and Mayo had 800,000 users in August, up from 55,000 at the beginning of the year.

Consumer sites are just the tonic for those seeking a wide array of medical research and news, as well as links to databases that explain diseases and drugs in laymen's terms. Moreover, many offer

sumers use a personal identification number or password to visit the site.

Julie Klapstein has already seen the benefits of Lexant's other services. The CEO of PhyCom Corp., a health-care software maker based in Kirkland, Wash., used Lexant's DoHealth service, which provides news and links to medical databases. This helped her pinpoint a condition that could have led to brittle

bones. "It's consumerism in health care. It's people taking charge of their own health," says Klapstein.

In a piecemeal fashion, the Net is bringing health care into the 21st century. The adoption of Web technology is expected to pick up even more as companies finish grappling with the Year 2000 bug. "There is a huge opportunity to give clients a much higher level of

service," says Eric Yablonka, chief information officer at Saint Raphael Healthcare System, a New Haven (Conn.) hospital that is installing Web software so physicians can look up patient data. With more such initiatives, the prognosis for health on the Net could be promising.

By Heather Green in New York, and Linda Himmelstein in San Mateo

POINT AND CLICK FOR PROZAC

Michael Bruner was shaken by what he learned in medical school. Not only was the state of health care in the U.S. worse than he had imagined, but he also decided that his ability to do much about it as a doctor would be minimal. So after some soul-searching and two years at the University of Pennsylvania School of Medicine, Bruner changed course. His new plan: to find a way to help patients manage their own well-being.

Two years later, Bruner, 30, is on the cusp of doing just that. With \$7 million from banks and Silicon Valley venture capitalists, he is readying the launch of PlanetRx, an Internet startup that will throw open its online doors late this fall. That's when the 15-person outfit will take on such giants as Walgreen Co. and Rite Aid Corp. by selling over-the-counter drugs, medical supplies, and prescription drugs—the latter being an \$87.8 billion market. "That's the sweet spot for consumers and for our business case," says PlanetRx Chief Executive William J. Razzouk, a former top executive from Federal Express Corp. who joined the company in September.

"LOTS OF COMPETITION." PlanetRx's ambitions go far beyond being just a cyberspace corner drugstore. The Oakland (Calif.)-based upstart plans to be a one-stop health shop, offering everything from expert advice from licensed pharmacists to allowing users to keep personal records of their prescriptions on the site. Bruner says that PlanetRx will provide consumers



ONE-STOP SHOP: Razzouk (center) and PlanetRx founders

with answers to medical questions their doctors and pharmacists don't have time to address. "The problem in health care is that patients, doctors, and pharmacists don't talk to each other," he says.

PlanetRx isn't the only one trying to fill that void. A bevy of players is scrambling to create online drugstores. From giants such as Kaiser Permanente to tiny startups such as PlanetRx and DrugStore.com Inc., the race to become the Amazon.com of health care is on. "I'm expecting lots of competition," says Peter M. Neupert, CEO of DrugStore.com, a Redmond (Wash.)-based fledgling that hopes to begin selling everything from cotton balls to Claritin early next year.

Maybe that's why Neupert, who spent 11 years at Microsoft Corp., is readying for all-out war. Sources familiar with DrugStore.com say he has snagged \$6 million from venture capitalist Kleiner Perkins Caufield & Byers, which backed Amazon, and has kicked in \$1 million of his own mon-

ey. They also say that Neupert is close to pocketing \$10 million from Amazon, which could be a potent move if DrugStore.com piggybacks on the online store's distribution and marketing muscle. Neither Neupert nor Amazon would comment.

The startups will need more than good marketing to counter the heavyweight rivals. In March, Merck-Medco Managed Care, which handles prescriptions for more than 51 million consumers, began allowing members to order their refills electronically. Walgreen start-

ed letting its customers order refills on the Web a year ago. And Rite Aid not only offers online refills but also reminds customers electronically when their prescriptions need refilling. "The Internet is ideal for delivering an online pharmacy and health-care service," says Martin L. Grass, CEO of Rite Aid, which sells about \$500,000 a month over the Net.

Yet for all this enthusiasm, dispensing drugs via the Web is fraught with peril. Unlike buying books, consumers may be concerned about security when it comes to placing drug orders or allowing a Web site to keep their medical profiles. PlanetRx thinks it has that licked with a system that makes unauthorized access to an individual's medical data virtually impossible. The company hopes this—combined with access to reams of medical data—will empower patients. And make PlanetRx a powerhouse at the same time.

By Linda Himmelstein in San Mateo, Calif., with Heather Green in New York

ODDLY ENOUGH, GETTING YOUR SCHEDULE STRAIGHT HELPS YOU KEEP YOUR PRIORITIES STRAIGHT



Address book



Date book

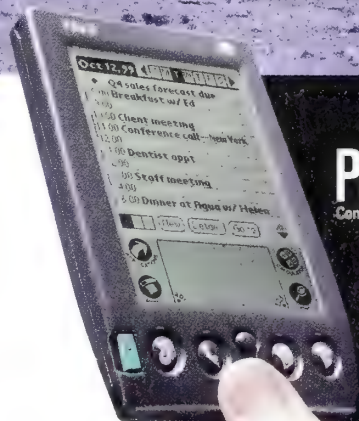


Memo pad



To do list

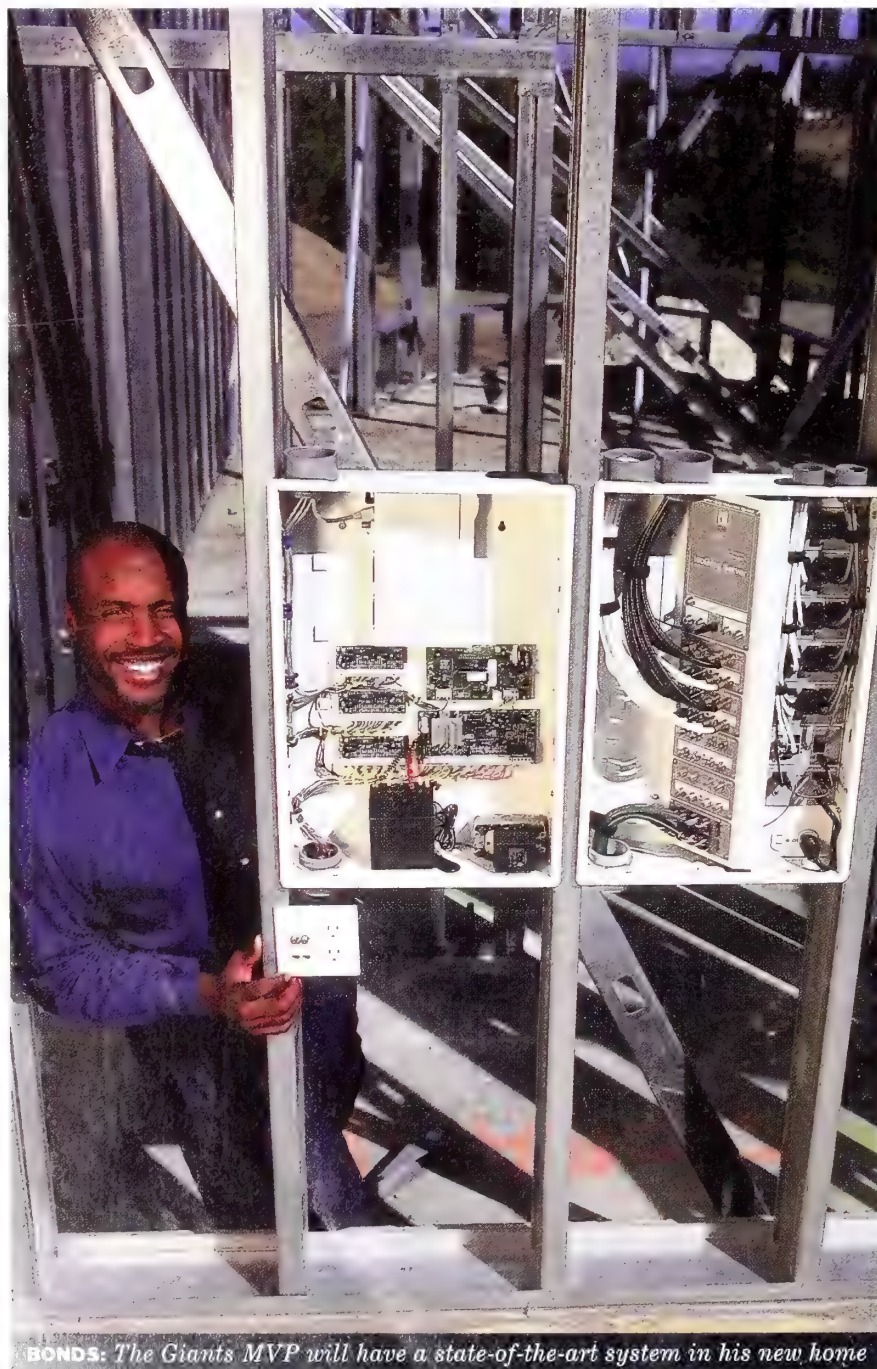
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WILL THE WIRED HOME PLAY IN PEORIA?

As prices dive, it's not just tech geeks who are buying



BONDS: The Giants MVP will have a state-of-the-art system in his new home

Barry Bonds is as serious about technology as he is about baseball. The three-time San Francisco Giants MVP is building a \$5 million home near Silicon Valley where he plans to have 10 personal computers that will let him easily tap the Internet from every major room, check the weather, or see who's at his front gate. To do this, Bonds is spending \$20,000 on a fancy wiring scheme that also will send data from one PC to another, spit out documents from a printer on the other side of the house. And the whole family will be able to share a single Net link. "I'm prewiring my house for the 21st century," Bonds says.

Until recently, only tech aficionados like the 34-year-old slugger built home networks. After buying gear from 3Com Corp., NetGear, and other suppliers, tech geeks installed network cards on PCs, strung wires through the attic and basement, and sweated the details of getting finicky networking software to run. There aren't many people willing to deal with those headaches. All told, only about 300,000 homes in the U.S.—or three out of every 1,000 families—have networks today, according to Forrester Research Inc.

Now, makers of networking gear are pushing to bring the Bonds-style networks popular in Silicon Valley to Middle America. The key, they believe, is a wave of new technologies that will allow average computer users to easily connect their home PCs on the cheap—without the hassles of running new wires through the walls. That could unleash demand: Some 15 million U.S. homes already have more than one PC, and the number is likely to double in the next few years, largely because of the rise of sub-\$1,000 PCs. By 2002, predicts Jon W. Todd, vice-president of Wedbush Morgan Securities Inc. in Los Angeles, 7 million households will be networked, creating a \$4.2 billion business for home-networking gear and software.

But what will motivate consumers to connect their home PCs and other information appliances? Money. With a home network, people with more than one PC won't need more than a single printer, modem, or Internet connection. Instead, PCs and other gizmos will connect to each other over a network, sharing peripherals and a single Net account. That could save hundreds of dollars in a multi-PC home. The technology will be especially compelling with the speedy digital subscriber lines (DSL) and cable-modem connections to the Net now making their way into homes. "Shared Internet access will be the killer app for

Jason Jones Took Action To Improve His Neighborhood

That's Why He's a Prudential Spirit of Community Award Honoree

*"I believe in giving back
to my community...
so others can
experience a better life."*

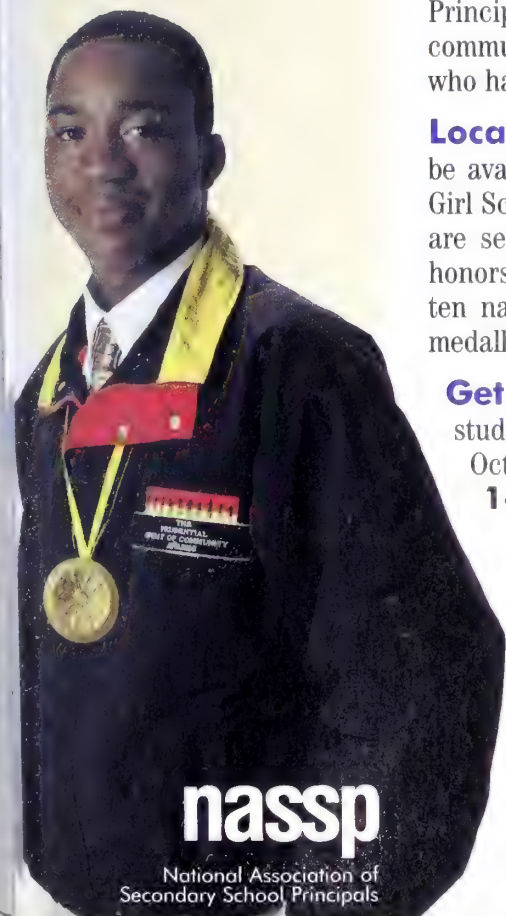
Jason Jones
1998 Prudential Spirit of Community
Award Honoree

Jason Jones, 14, of Columbus, Georgia, saw an opportunity to improve his community—and he took it. He started a neighborhood advisory committee, clean-up campaign and food drive that have helped bring a renewed sense of pride to his entire community. That's why he's a 1998 Prudential Spirit of Community Award honoree.

The search for 1999 candidates is now under way. Prudential created the Spirit of Community Awards in partnership with the National Association of Secondary School Principals to honor young people like Jason for outstanding community service. We're looking for young people in grades 5–12 who have taken it upon themselves to help their communities.

Local, state and national awards. Applications will be available in September through middle schools, high schools, Girl Scout Councils and county 4-H organizations. Local honorees are selected in November and become candidates for statewide honors, a \$1,000 prize and a trip to Washington, D.C. In the capital, ten national honorees will each receive a \$5,000 award, a gold medallion and a crystal trophy.

Get involved today! If you know any volunteer-minded students, encourage them to apply. The application deadline is October 30, 1998. For more information, call the NASSP at **1-800-253-7746 ext. 324.**



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home networking," says Forrester analyst Bruce Kasrel.

Companies are swarming to get a piece of the budding market. Over the past 18 months, venture capitalists and corporate investors have dumped more than \$140 million into a dozen startups chasing home networking. Industry giants Intel Corp. and Microsoft Corp. are investing heavily in it, believing it will help sell PCs. At the same time, traditional networking companies, such as 3Com and Bay Networks, will roll out home-networking products in the first half of next year. "This is a big-ticket game," says Wedbush Morgan's Todd.

Maybe. But will home networking play in Peoria? Even though the technology is getting simpler to install, it faces several challenges. Perhaps most

significant, many people don't see a need for a network in their home. Robyn Roberts and her husband, who together run an online investment service from their Woodside (Calif.) home, already have network wiring built into the walls of their new house. But they've decided not to connect their six PCs and four printers. "We don't need to be attached," says Roberts. "And it would be a real disaster for us if the network went down."

ONLINE PARTY. Increasingly, however, consumers are warming to the notion of a wired home. Jon Toolson, a retired engineer living near San Diego, recently plunked down \$170 for a two-PC wireless-networking kit called Aviator Wireless Network, from San Jose (Calif.) startup WebGear Inc. Aviator plugs into PC printer ports and broadcasts data around Toolson's house at 1 megabit per second (Mbps). That's only one-tenth the speed of most wired office networks but 25 times faster than the speediest modems on the market. Toolson uses it to connect his PC to his wife's—allowing them to share one printer. Best of all, it lets them both go online simultaneously, through a single modem. "We used to have to take turns," Toolson says. "Sharing the modem just amazes me."

There are three ways to get as connected as the Toolsons. Companies such as Tut Systems Inc. and Epigram Inc. are devising methods for sending data

over the telephone wiring already built into every home. Intellogis Inc. and Intellon Corp. aim to use electrical wiring. And the largest group, led by WebGear and ShareWave Inc., is trying to cut the cord entirely with wireless radio networks. The common goal: to create networking schemes that cost \$100 or less per connection and are as easy to set up as home stereo systems. Says Neil Clemmons, vice-president for consumer marketing at 3Com: "You have to be able to get it installed and operating within 15 minutes."

Or less. The approach of Intellon and Intellogis is as simple as it gets: If their technology is built into PCs, just plugging your computer into a wall socket would put it on a network. Though PCs won't ship with the technology until

send data at 1 Mbps through phone wiring. The company, which lost \$1 million on sales of \$6.2 million in 1997, backed by \$39 million in capital from venture-capital firms and corporate investors including Microsoft, Compaq Computer and AT&T. With products from licensees set to hit the market by Christmas, it expects to go public soon.

DIGITAL MAGIC. Tut has a rival hounding its heels. Startup Epigram in Sunnyvale, Calif., says it can zip data over home phone wiring 10 times faster—the same speed as office networks. That's fast enough to move more than just Web pages: Epigram aims to let users ship digital voice and video around their homes, for instance, linking an iVid videodisk player in the living room with a TV in the den. Like Tut, Epigram will license its technology to chipmakers and networking companies, though Epigram's products won't be introduced until next year.

Startup ShareWave has the same vision of multimedia networking, but without using wires at all. The El Dorado Hills (Calif.) startup has \$42.5 million in funding—and is the first ever to be backed by the computer industry's big three—Intel, Microsoft and Cisco Systems. ShareWave's wireless technology will use small transmitters built into PCs. When ShareWave licenses ship products in early 1999, they'll be able to transmit data at 4 Mbps over radio waves—fast enough to carry compressed digital video. The price is

not set, but it's expected to cost less than \$100 per PC.

By this time next year, analysts expect home networking could be built into most new PCs. But even if it's virtually free, computer and networking companies will need help getting people to use it. That's why it'll be critical to win support of the cable and phone companies that offer high-speed Net access—and could be prime distributors of home networking gear. By 2002, Forrester projects, nearly 16 million U.S. homes will be served by DSL and cable modems. That could provide strong impetus for growth. Still, networking makers will have to hope that more than just baseball fans aspire to be like Barry Bonds.

By Andy Reimold
in San Mateo, Calif.

Home-Networking Technologies

TECHNOLOGY	PLAYERS	STATUS
WIRELESS 	Proxim ShareWave InTalk WebGear Diamond Multimedia	This used to be the most expensive choice, at \$350 or more per PC. But prices are falling to less than \$100. Speeds are 1 to 4 Mbps. May be used for video and Net phones, not just PC data. Biggest advantage: mobility.
PHONE LINE 	Tut Systems Epigram	Could be the cheapest—at well below \$100 per PC—if built into PCs and modems. Speeds from 1 Mbps to 10 Mbps. Strong momentum, but many rooms in homes lack phone jacks.
POWER LINE 	Intellogis Intellon	Easiest technology to install, but the slowest, at 350 Kbps to 1 Mbps. Price is moderate, at \$125 per PC, but there are security concerns.

DATA: COMPANY REPORTS, BUSINESS WEEK

next year, Lynn Carter recently bought a \$250 PassPort Plug-In Network from Intellogis for his Utah home. In the past, his five kids, who have their own PC but no phone line in their play room, were constantly using Carter's modem-equipped PC to get on the Net. Now, they can surf the Web from their own machine using Carter's modem—even when he's doing other work on his PC. "You can't even express the beauty of this thing," Carter says.

Almost as simple is using home phone wiring for a network. With just one wire from the PC to a phone jack, customers will be able to link to the Net and simultaneously connect with other PCs in their homes. The leader in this category is Tut Systems in Pleasant Hill, Calif., which has devised a way to



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GOING SOUTH UP NORTH

Growth is faltering. Will Canadians lose their social perks?

As a high school guidance counselor, Joe Santalucia usually exudes optimism. Not these days. Locked out of his Toronto school from 8 to Sept. 28 in a province-wide strike over budget cuts and working conditions, he sees less security and leaner times looming. "The government is trying to balance the books, so when we go to the hospital, we have to wait five days," says Santalucia, 42. "Education

is suffering. We will have to live with less and less."

Across Canada, the good life is in jeopardy, threatened by a mix of government spending cuts, gloomy economic forecasts, and the deepening global crisis. Signs of trouble abound. Interest rates are up in an effort to bolster the Canadian dollar, now scraping along at historic lows against the U.S. dollar (chart, page 162). Labor peace has col-

TORONTO TEACHER: *Labor peace has collapsed*

lapsed amid strikes by teachers, airline pilots, mill workers, and even doctors. The jobless rate, which has been slowly falling from its 1992 peak of 11%, is expected to stall at more than 8% next year. "The economy is fragile," says John Lester, chief economist for brokers CIBC Wood Gundy Inc. "It is on a mediocre growth path and really very vulnerable."

That's a sharp turnaround from just over a year ago. Then, Canada's outlook was brighter than the Northern Lights as it got a big lift from booming U.S. and Asian economies. With gross domestic product barreling toward a nearly 4% rise in 1997, Canada set the pace among the Group of Seven industrial powers. Today, it is burdened with unsolved problems: huge debt, high taxes, and a costly government role. And as the Asian crisis spotlights national weaknesses, investors are treating Canada like an emerging market. Their wari-

ness is reflected in risk premiums of 49 to 60 basis points that Canada is having to pay on its Treasury borrowings over comparable U.S. Treasury bills.

Certainly, the Canada that emerges a couple of years from now will be markedly different—and many Canadians won't like it. Already, stalwarts such as forest-products giant MacMillan Bloedel Ltd. have cut staff to contend with low commodity prices. A slowdown could force restructuring on a broad range of manufacturers. And government will have to scale back even further. Says Joshua Mendelsohn, chief economist at Canadian Imperial Bank of Commerce: "The Canadian public will have to accept a somewhat leaner system that doesn't cater to every whim."

For two generations, Canadians have been growing accustomed to a comfortable welfare state with benefits from fully paid health care to heavily subsidized education through graduate school. As recently as 1991, government spending accounted for more than half of the country's GDP—but at a high price. Canada piled up a \$349 billion net debt, the industrial world's biggest after Italy as a percentage of GDP.

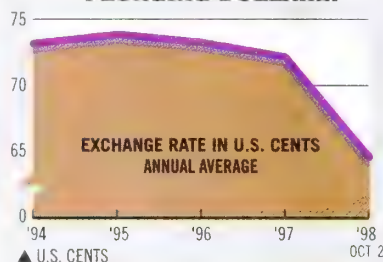
Recognizing that Canada was living beyond its means, the Liberal government reined in spending in 1994 and balanced the budget in the last fiscal year. Cuts in social programs have sparked protests, ranging from teachers in Ontario to doctors in western Canada. Even though economists predict a meager GDP gain of little more than 2% next year, the federal government vows to hang tough. "We are not going back into deficit," vows Finance Minister Paul Martin. "This country is in the black, and it is going to stay there."

While the government keeps the brakes on spending, the Canadian economy is being hurt by commodity deflation as a result of the Asia crisis. Canada remains the G-7 nation most dependent on natural resources, from nickel to tar sands. Falling prices are hammering the sector, which accounts for 10% of GDP and 35% of merchandise exports. No wonder Canada's stock markets are making hard-pressed U.S. markets look like oases of calm. While the Dow Jones industrial average is off 16.6% from its July high, the Toronto Stock Exchange's 300-stock index is down 29.5% from its April peak.

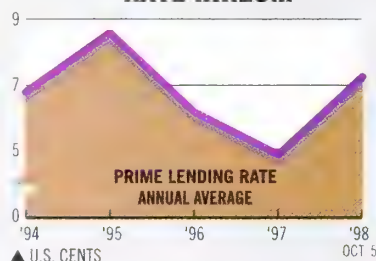
Canadians recognize the risks of relying on commodities. "They are not going to provide us with the standard of living we need," says Jock A. Finlayson, an economist at the Business Council of British Columbia. Indeed, natural re-

sources' share of exports is down by nearly one-half from what they claimed in 1980. Still, continuing dependence on commodities keeps Canada on an economic roller coaster. Forecasts of even 2% growth next year could prove optimistic, if other economies tank. "If we have more shocks to the system, all bets are off for everybody," warns Thomas d'Aquino, CEO of the Business Council on National Issues, a group of 150 top business leaders.

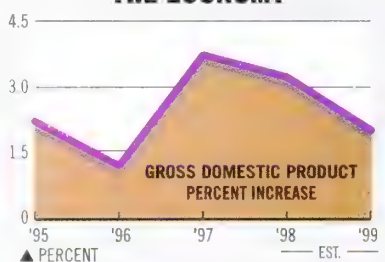
CANADA'S PLUNGING DOLLAR...



...HAS TRIGGERED RATE HIKES...



...THAT ARE BRAKING THE ECONOMY



DATA: CANADIAN IMPERIAL BANK OF COMMERCE, BUSINESS WEEK

The sliding Canadian dollar poses another worry. Not only is it making imports more costly, but moves to shore it up have proved problematic. Anxious about the loonie's 12% plunge in 12 months, to just over 63¢ (U.S.) in late August, the Bank of Canada has spent billions propping it up and has raised interest rates repeatedly. Its biggest move, on Aug. 27, hiked the prime rate a full percentage point, to 7.5%, though a recent cut that mimicked the Federal

Reserve has since pared the prime to 7.25%. Still, steep borrowing costs now threaten to choke off growth. "Another 100 basis points could kick the economy into recession," warns CIBC Wood Gundy economist Lester.

Canada wasn't always so vulnerable. The loonie fetched more than \$1 in 1980 and was approaching parity in 1991. But since then, while noncommodity sectors have grown, the shift toward high tech hasn't been fast enough. Despite such telecom powerhouses as Northern Telecom Ltd. and Newbridge Networks Corp., Canada hasn't kept pace with hot-growth incubators like Silicon Valley. "There are 50 times more technology companies in the States," complains Newbridge Networks Chief Executive Terence H. Matthews.

Canada's difficulty in nurturing cutting-edge industries stems from policy mistakes. As politicians have groveled about Canada's more caring and compassionate society, they have boosted taxes steeply to pay for it. With even modest earners winding up near the 50% bracket in federal and provincial taxes, talent has looked south for more lucrative opportunities.

"NANNY STATE." But Canada has a long and burdensome legacy of Big Government. Years of overspending since the mid-1970s piled up net government debt that now equals an estimated 60% of GDP, far above the 46% level in the U.S. Even with the Liberal government's current penny-pinching, public outlays still account for nearly 42% of GDP, less than 32% in the U.S. "We are a nanny state, big-time," complains Ed M. Mihlar, director of regulatory studies at Vancouver's Fraser Institute.

While the opposition Reform Party and business leaders call for lower taxes, no Canadian Ronald Reagan has arisen with a mandate for deep cuts. Liberal Prime Minister Jean Chrétien has suggested that the next federal budget pare taxes, but he is shunning radical steps such as privatizing health care, a move that would violate Canadian mildly socialist mind-set. "Those are very enduring values that are deeply embedded in the Canadian way of thinking," says Ralph Goodale, federal minister of natural resources.

Nevertheless, such values may be fast growing obsolete and unaffordable. If hard times spread, the government will be pressed to retrench or change. Otherwise, its political prospects will collide with harsh economic forces. Either way, Canada's caring and compassionate society faces sore testing.

By Joseph Weber in Toronto

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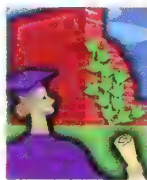
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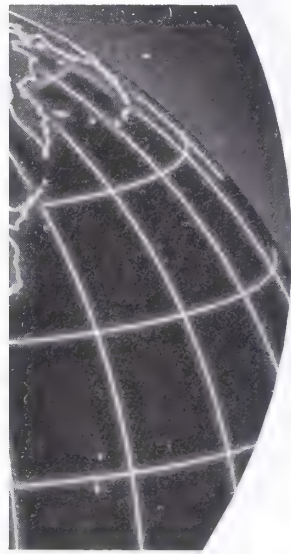
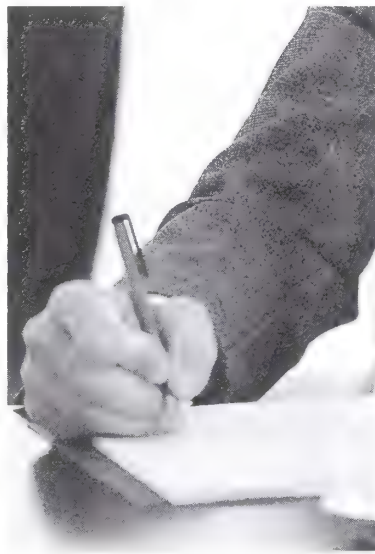
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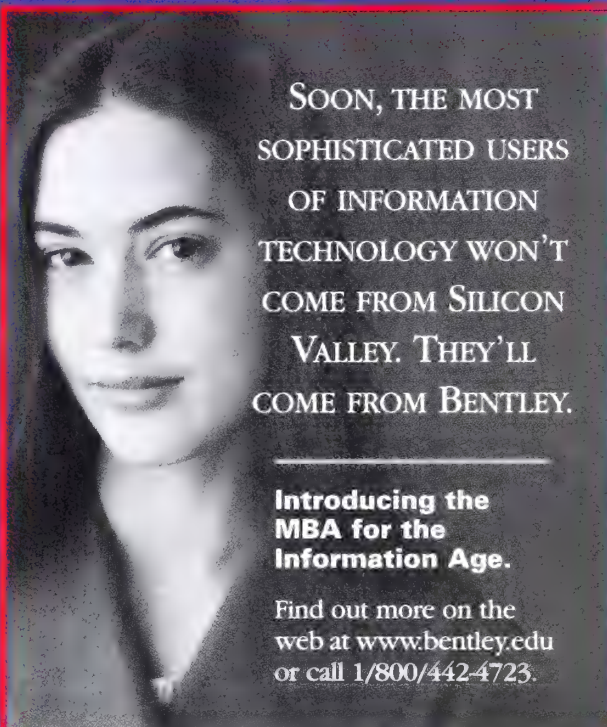
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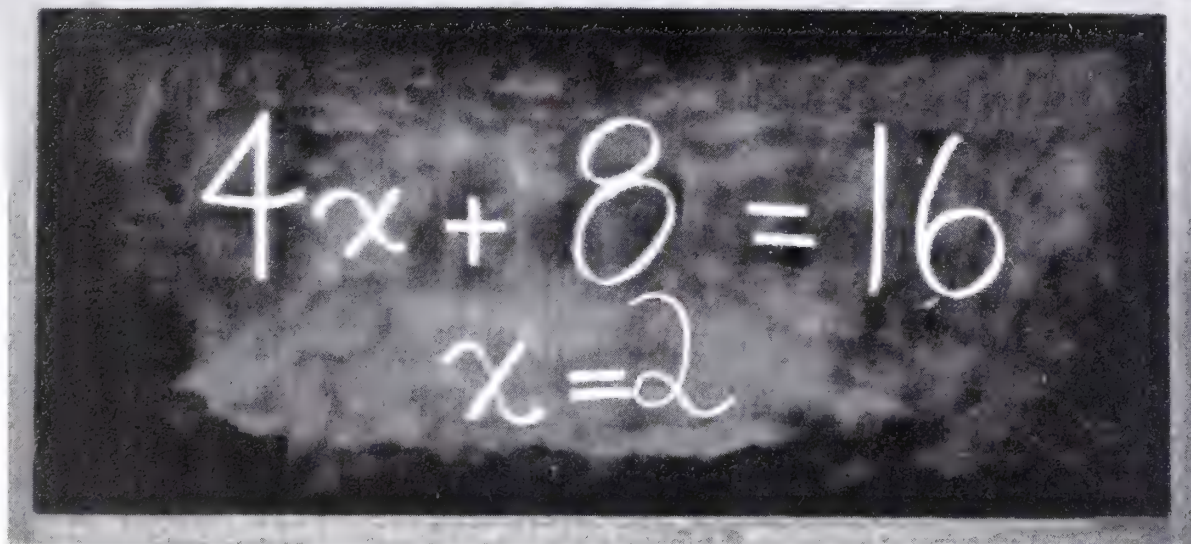
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COMMENTARY

By Keith H. Hammonds

HMOs: LISTEN TO YOUR PATIENTS—OR ELSE

and so it has come to pass that, once again, health-care reform perishes. It had no chance, really, caught up in Monica-rama and the aspect of impeachment proceedings, legislators readily ditched their comparatively tame effort to make managed-care industry play nice. When Congress folds its tent on Oct. 1, the putative Patient Bill of Rights quietly expire.

This is a rare bit of good news for us, currently suffering their third annual profit drought. The bill of rights, after all, was hardly industry-friendly. Various versions would have given consumers freer access to sue their plans for personal injury; required external review processes to appeal insurance coverage decisions; and guaranteed payment for emergency room treatment.

So HMOs dodged a bullet. Now, if managed-care insurers have any instinct for self-preservation—and recent evidence suggests that debatable—they'll figure how patient protection became a *se célèbre* in the first place. Find the right answer, and they have a chance to regain validity as a central part of the nation's health system. We're the lessons, and they're dead.

REAL CHOICES. Lesson No. 1: Health care is becoming a consumer-industry again. For 50 years, employers and the government have made most people's medical bills, insulating patients from any real decision-making roles. Today, employers are beginning to back off, making workers more of the tab but also giving them more flexibility in health coverage options. Consultants Booz Allen & Hamilton says as many as 60% of large companies are mulling a switch to "defined contribution" health plans. Rather than guaranteeing coverage in medical coverage, these employers offer a fixed sum toward insurance, leaving employees to pay the difference.

As consumers increasingly are expected to purchase their own medical care, with considerable financial incentive to seek value. Here's where Lesson No. 2 comes in: Consumers

don't like HMOs. No matter that HMOs' care appears to be as medically sound as any other. Americans are far more likely to trust their physician than they are the insurer, which is often perceived as meddling needlessly.

Patient-protection legislation would have eased consumer angst by forcing insurers to accept some measure of accountability. With HMOs' black boxes pruned open, patients at least would have enough information to make

Bleeding Edge, a critique of the health-care system. Consumers are likely to choose dealing directly with doctors and hospitals, just as they did before HMOs became the norm.

Envision the ultimate consumer-driven health-care market—something Booz Allen partner Philip Lathrop calls "HMOs 'R' Us." In this world, consumers armed with defined-contribution dollars from employers choose from a multitude of physicians and



As consumers pick up more of the health tab, they'll have more clout in choosing providers

sound decisions and get a clear picture of what was and wasn't covered. "There's a need for some ground rules...to protect people from anxiety," says Robert Blendon, a Harvard University professor of health policy.

Without Congress' protection, consumers simply will seek it out in the marketplace. Already, patients have forced insurers to broaden their networks of doctors and hospitals, so that most networks look pretty much alike, or have pressed to see doctors outside the network altogether. Good-bye, cost containment.

Consumers will throw even more weight around as employers force them to take on a larger share of their health costs. The result will be "insurers' marginalization," says medical economist J. D. Kleinke, author of

plans at an online supermarket—much as investors scout out mutual funds. The information at their disposal is nearly limitless; so are their options.

Will they choose HMOs, best-known at present for their bureaucracy and callousness? The supermarket scenario is at least a decade off, but the managed-care industry would do well to consider the ramifications right away. Many industry execs won't bother. Medicine is too complex for the average Joe, they say, and the data that would help people make informed decisions don't yet exist. That's true—for now. HMOs may be surprised at what's possible, though, when unhappy patients get handed the purse strings.

Hammonds writes on social issues.

EDITED BY AMY DUNKIN

GETTING THE MOST FOR YOUR B-SCHOOL MONEY

The 1990s are the Golden Age of MBAs. Since 1990, average starting salaries for graduates of the top 25 business schools have jumped 30%, to about \$77,500, according to data from BUSINESS WEEK's student surveys. Applications to B-school have soared, and this fall some 30,000 students at 300 accredited schools are starting the two-year program they hope will transform their careers from mediocre to meteoric—and make them rich in the bargain. There's just one smudge on this otherwise bright picture: You could practically start a business on the \$75,000 to \$200,000 it costs to get through B-school today.

That raises a question: Just how good a deal is an MBA? Is the return on your mortgage-size investment worth trading your current profession for two years of B-school hell? Before you say "Duh!," remember two things: Demand for MBAs fluctuates with the economy and stock market. And the amount of time it takes to earn back the cost of a degree varies dramatically, depending on the school you attend and the job you land. While you can't do much about the economy, you might want to factor in a school's return on investment (ROI) when making your picks.

To help you do that, BUSINESS WEEK once again asked Jens Stephan, academic

director of MBA programs at the University of Cincinnati, to help us figure out which schools offer the fastest and slowest ROI (taking into account tuition and other costs). Stephan, who helped launch BUSINESS WEEK's first ROI project in 1996, this time used the data collected from 61 members of the Class of 1996 at 61 B-schools.

The winner for the second time in a row was the University of Pittsburgh's Graduate School of Business. The one-year program produced the best projected turn—a median ROI of 4.8 years. Close behind, with a median ROI of 3.8 years, was Clark Atlanta School of Business Administration, a minority-oriented two-year program based in Atlanta.

THE BEST B-SCHOOLS RETURN ON INVESTMENT

the other end of the spectrum, grads of Case Western Reserve-Weatherhead School of Management are expected to need 7.2 years to break even on the cost of their MBA. Harvard Business School grads will need 5.7 years. **WRITING CHECKS.** On balance, the news is good: Business school looks like a better deal than it was in 1996. Stephan says it will take four to six years for the Class of 1996 to recoup its investment—from the five to eight years projected in 1996.

That's an encouraging sign, especially since B-school is the biggest investment for most entering MBA students, with an average of \$26,000, will have made. The average \$40,000 for two years of tuition (based on pri-



s) plus \$80,000 or in missed salary the jobs left be- (Nearly all B- in our survey re work experi- Those who like ig checks can for Harvard or rd, the two most sive B-schools, costs (including ne salary) are 23 and \$183,846, tively.

calculate a 's ROI, Stephan oks at a student's ment—the two of tuition and the ears of foregone gs from the pre- job. Next, he grad's post-MBA to a signing and other com- ion (guaranteed d bonus, reloca- osts, etc.) and ts the pre-MBA

He then deter- a grad's MBA pay e, starting the ck in Year One school. In Year e uses the salary e plus half of the year's signing and other com- on. That's be- t's unlikely stu- vill take a huge after their first- nus. From that n, Stephan as- a 10% salary in- less than a Wall anker sees, but

double the average r U.S. managers. tops the list because program lasts only r, halving the invest- f its students. More- e Class of 1998 walked ith a 69% salary in-

The Quickest Payback...

SCHOOL	TOTAL INVESTMENT*	AVG. LOAN AT GRADUATION	% SALARY INCREASE	ANNUAL RETURN ON INVESTMENT**	MEDIAN YRS. TO PAYBACK***
U. OF PITTSBURGH	\$75,800	\$28,000	69%	38%	3.7
CLARK ATLANTA	101,300	36,000	100	43	3.8
U. OF SOUTH CAROLINA	81,500	35,000	107	41	4.0
U. OF TENNESSEE	88,000	18,000	91	38	4.1
BRIGHAM YOUNG U.	82,900	20,000	100	43	4.2
ARIZONA STATE	93,900	19,500	103	39	4.3
MICHIGAN STATE	98,400	26,000	110	38	4.3
U. OF IOWA	93,900	18,500	100	38	4.4
YALE	147,200	40,000	111	36	4.7
UNC-CHAPEL HILL	128,000	25,500	78	38	4.7
CARNEGIE MELLON	158,800	40,000	82	30	4.8
PURDUE	110,600	24,000	91	36	4.8
MICHIGAN	161,800	40,000	77	32	4.8
SUNY, BUFFALO	75,900	14,000	75	22	4.8
CORNELL	156,200	50,000	79	35	4.8

...And the Slowest

CASE WESTERN	128,800	31,000	79	18	7.2
BABSON	146,500	42,000	75	24	6.7
UC DAVIS	129,150	19,000	70	19	6.3
BOSTON U.	131,600	50,000	88	19	6.0
TULANE	137,900	33,500	97	27	6.0
WISCONSIN	107,300	17,000	95	29	5.8
EMORY	149,500	37,000	75	21	5.8
HARVARD	196,900	50,000	50	33	5.7
WAKE FOREST	125,400	42,500	82	24	5.6
NOTRE DAME	142,700	30,000	68	23	5.6
AVERAGE SCHOOL	129,200	36,000	81	30	5.2

*Two years of lost earnings plus the pretax income needed to pay the tuition **Uses compound formula based on:

Post-MBA salary (including yearly raises) minus pre-MBA salary/total investment; assumes out-of-state tuition

***When the paid gain as a result of the MBA equals the total investment in B-school. Includes time spent in school

DATA: BUSINESS WEEK, JENS STEPHAN, UNIVERSITY OF CINCINNATI

crease over its pre-MBA income. For the rest, all of which require two years of study for most of their students, there are essentially two paths to the top of the ROI list: particularly low tuition or unusually high pay

gains over pre-MBA incomes for new grads. The first group is populated mainly by public schools, such as the University of South Carolina, University of Tennessee at Knoxville, Arizona State, Michigan State, and the University of Iowa, which boast an average payback period of 4.2 years for out-of-staters. In-staters get an even better deal: 3.8 years.

On the salary side, the leader is the Yale University School of

Management. Even though Yale's tuition was \$23,100 a year, starting pay for its class of 1998 averaged \$80,000, an 111% gain over grads' pre-MBA salaries and the highest percentage increase in our universe. A reason for the big gains: Yale attracts a large group of nonprofit and government workers, who tend to be lower paid. Clark Atlanta and Brigham Young University's Marriott B-school, also private, turned in high ROIs with a mix of modest tuition and high percentage salary gains.

HEAVY HITTERS. Most laggards on the ROI list are private schools. They tend to charge the highest tuition, and, in some cases, students come from high-paying jobs, so their percentage increases in post MBA pay are only average. Harvard, for example, charges \$25,000 for tuition, while its grads leave the school with only a 50% pay increase from their pre-enrollment \$60,000. That compares with an 81% average salary increase for grads of the top 61 schools.

For the first time this year, we also calculated ROI by career choice—and found that

the occupations posting the best ROI were finance, consulting, and marketing (table, page 178). It's not surprising, then, that 63% of the survey respondents chose finance or consulting for a post-MBA job. Other tracks were operations, information technology, entrepreneurship, accounting, human resources, and nonprofit. MBAs who went into consulting gained an average salary increase of 96%, while students who chose to work for not-for-profit ventures, the lowest paying job track, ended

The Class of '98 will take four to seven years to recoup its investment



WINNING COMBO

Pitt topped the list again because its program lasts only a year, and its grads enjoyed a 69% salary hike from their pre-MBA income

up with only a 40% raise.

Oddly enough, the heaviest hitters in finance and consulting—University of Chicago, University of Pennsylvania's Wharton School, Columbia, Stanford, and Harvard—don't stand out any more in the job-track comparison than they do in the school-by-school comparison of ROI. Instead, it's Yale's grads, again, who pull down the highest increase in starting salary. Yale placed 39% of its 998 grads into consulting positions, netting them a 154% pay increase.

Bart Borosky, a 1998 Yale grad, is a case in point. A product manager in the high-tech industry, he wanted to switch careers. "Getting your MBA, you can do anything," he says. "But you have to pay for your education, so I was hoping to make more [money] coming out than going in." His

new job as an operations consultant at Booz Allen & Hamilton pays in the low six figures, twice what his old one did.

In the finance track, Iowa and Brigham Young provide the quickest return as low tuition and pay gains of 105% and 148%, respectively, give them a payback period of just 3.5 years. In info tech, Arizona State had the fastest ROI time—four years, thanks to salaries more than doubling.

While the ROI analysis offers a lot, it doesn't take into account intangibles such as the all-important alumni network. Says Stephan: "It does not capture the long-term benefit of the MBA or the 'reputation effect' of a school. It's a short-to-intermediate-term analysis." That point was dramatized by a survey BUSINESS WEEK did in 1992 of alumni who had graduated from one of the top 25 MBA programs five years earlier. While the difference in average starting salary for Stanford and Indi-

ana grads coming out of school in 1988 had been \$30,000, five years later the gap had more than tripled.

Still, investing \$180,000 in a degree from a top-tier B-school vs. half that amount at a school that isn't quite as prominent is a tough decision. Take Nat Marwaring, a 28-year-old accounts manager at Procter & Gamble, Salt Lake City and '98 grad of the University of Tennessee. Knoxville's B-school No. 4 on the ROI roster. He worked for a Chinese transportation company before returning to school. He

cluded it was cheaper to attend UT as an out-of-state resident than to apply at the University of Virginia's darden School as an in-state resident. In his new P&G job, he tripled his earnings, not including his signing bonus. He has no loans, and, like a typical UT grad, will pay back his entire MBA investment in roughly four years, including the two he spent in school. That's not a bad deal—one among many that merit a close look at a school's ROI. Nadav E.

Returns on Careers

JOB CATEGORY	TOTAL INVESTMENT*	SALARY INCREASE, POST-MBA	YEARS TO PAY BACK	JOB CATEGORY	TOTAL INVESTMENT*	SALARY INCREASE, POST-MBA	YEAR TO PAY BACK
CONSULTING				ENTREPRENEURSHIP			
FASTEST Pittsburgh	\$78,300	64%	3.3	FASTEST Emory	\$109,500	250%	4.1
SLOWEST Rochester	152,200	85	6.5	SLOWEST Stanford	211,800	9	9.1
AVERAGE	128,800	96	4.6	AVERAGE	139,900	54	6.1
FINANCE				INFO TECH			
FASTEST BYU	72,900	148	3.5	FASTEST Arizona State	89,877	120	4.1
SLOWEST Babson	144,600	67	8.1	SLOWEST Harvard	206,900	35	7.1
AVERAGE	130,600	71	5.1	AVERAGE	129,800	67	5.1
MARKETING				OPERATIONS			
FASTEST Pittsburgh	75,300	80	3.3	FASTEST Pittsburgh	68,300	125	2.1
SLOWEST Columbia	177,400	40	7.8	SLOWEST Yale	135,200	128	8.1
AVERAGE	127,600	84	5.5	AVERAGE	133,200	76	5.1

*Two years of lost earnings plus pretax income needed for tuition. Calculated from student survey respondents within each job track. Averages are from BW student surveys of 61 schools. ** Same payback time as Iowa, but higher salary increase.

DATA: BUSINESS WEEK, JENS STEPHAN, UNIVERSITY OF CINCINNATI

GETTING A LEG UP AND PAYING THE PRICE

business school applicants are looking for a boost, they sometimes turn to two sources: test preparation courses and admissions consultants. Many students think they're useful enough to be worth the hundreds, even thousands of dollars they cost. But evidence is mixed on whether they can assure you a higher GMAT score or a favorable reception at the admissions office. BUSINESS WEEK evaluated both methods, and here's what we found:

THE GMATs: PREP OR NOT TO PREP

If you grew up in the suburbs when Guess? jeans were "rad," Ferrell Bueller was a hero, and standardized testing meant whipping out pencils. Now, you're a senior, and you're fretting about the GMAT, the admissions test everybody now takes on a graduate level. The Graduate Management Admission Test is likely to be a pain in the neck for a long time many Generations (and late-blooming ones, for that matter) who have taken an exam on a college level, that's the only one you can take it. This is the only test that is required for admission to Princeton and Kaplan Educational Centers' test-prep has boomed in the last few years. Why, if you're heads-down, you may be about plunking down \$1,000 for a course.

ALL GAME. The new test is similar in content to the old one, with verbal and quantitative sections and two essays. The digital test has different ground rules. For the first time, questions must be asked in order. That means you can't jump to the easier questions and save the puz-



zlers for later. You're also penalized for not finishing all the sections. So guessing—and knowing how to eliminate incorrect answers—is more important than ever. Perhaps the biggest change, however, is that the test is adaptive. How well you do on early questions determines how hard the questions will be later. And the difficulty of the questions, not just the number you get right, affects your final score.

Adding to the pressure, you now must decide before you leave the room whether you want to cancel your score so it doesn't count. Otherwise, you get the multiple-choice results immediately. On the old paper

test, a test taker had one week to cancel and didn't find out the grade for more than a month. Even now, you still have to wait for your essay grades, but they don't contribute to the main score, anyway.

As a result of the changes, more students are clamoring for test review, and Kaplan saw profits of its GMAT division climb 35% last year, compared with a 15% increase for its overall test prep division. Meanwhile, Princeton

Review's GMAT enrollment increased 20%. "People want to prepare more for a test that's in a format they are not used to," says Cathryn Still, managing director of GMAT programs for Princeton Review.

But you may want to think twice before signing up for such a class. Many MBAs say that in retrospect, they could have prepared just as well on their own. In fact, in BUSINESS WEEK's survey of 6,020 recent

B-school graduates at 61 top programs, no area of education received lower marks on average than GMAT test prep courses. On a scale of 1 to 10, students who took such classes gave them a 6.1. "When you pay \$800 for a preparation course," says Michael Strohl, a '98 MBA from the University of Washington, you expect "the instructor to provide more than commonsense exam-taking tips."

A Kaplan or Princeton course still may be right for

some applicants. For example, if you want to review specific subject matter or discuss test-taking strategy, the classes can be valuable. If nothing else, paying the steep fee inspires applicants to prepare more rigorously.

EXTRA TUTORING. So which course should you take? Compare both to see which curriculum better meets your needs. Princeton, for example, caps its classes at 15 students, compared with 25 at Kaplan. Princeton also wins kudos for requiring the

teacher to schedule one-on-one sessions as often as students request. "For a fixed price, you get the structured course as well as all the extra tutoring you need," says Jennifer Meyer, a recent Kellogg

THE BEST B-SCHOOLS TESTING

What to Expect from A GMAT Cram Course

COMPANY	KAPLAN	PRINCETON REVIEW
MAX. COST	\$1,000	\$1,000
MIN. CLASS TIME	27 hours	30 hours
NO. OF COMPUTER PRACTICE TESTS	10 at Kaplan computer centers	5 over the Internet

MBA. Kaplan offers extra-help sessions but not always with the same person.

Before the GMAT was computerized, applicants showed a preference for Princeton Review. This year's grads of BUSINESS WEEK's top 25 B-schools gave it an average score of 6.5, compared with 5.8 for Kaplan.

Kaplan says the comparison is unfair. Picking Princeton because of the BUSINESS WEEK survey results, says

Kaplan Vice-President Melissa Mack, "is like shopping for a car that's undergone new model relaunches, using a 1993 edition of *Consumer Reports*." In fact, both companies have made major changes to their courses since the GMAT went high tech, and Mack says Kaplan has one clear advantage: It has its own computer labs and offers students more chances to take sample computerized tests (table, page 179).

Of course, you don't need to drop a grand to take a sample GMAT. You can still buy a host of review books for about \$20 each. Or you can use practice software. The Graduate Management Admission Council, which administers the GMAT, offers a review guide and POWERPREP software (\$70 for both), including two complete tests. You can order the package from www.gmat.org, where you can also download a list

of essay topics for the Princeton Review (www.review.com) offer book and CD-ROM and four practice tests for And Kaplan sells software review packages for (www.kaplan.com).

So if you've got the discipline, you may be able to save hundreds of dollars without costing yourself GMAT points.

Sara Leitch and D. Leonhardt

IS A HELPING HAND REALLY HELPFUL?

Daniel Gomes thought he had a good shot at getting into a top B-school. A Brazilian with more than four years work experience in São Paulo at Quaker Oats and Banco Safra, Gomes decided to go for an American MBA in October, 1995. But "English is not my first language," he says. Plus, "I had only two months to study for the GMAT, and I wasn't familiar with the application process in the U.S."

So Gomes tried to give himself an edge. He spent about \$3,000 for 30 hours with Patricia Montero, a São Paulo admissions consultant who helped improve his English and organize applications



THE BEST B-SCHOOLS CONSULTING

to Wharton School of Business and the University of Michigan. Wharton rejected him, but he got into Michigan, graduated last spring, and took an \$85,000-a-year job as an associate consultant at McKinsey in São Paulo.

With selectivity at an all-time high at the best schools, should you seek out an admissions consultant? "I probably could have gotten the same help from the admissions people"—for free, says

Grace Cragin, a recent Wharton grad who used MBA Strategies. Nonetheless, of the 6,020 students in the top 61 programs responding to BUSINESS WEEK's B-school survey, 2.7%, or 163, said they used a consultant. For a few hundred to several thousand dollars, consultants offer you inside connections from their previous jobs at B-schools, tips on interviewing, and essay critiques.

MBA Strategies, one of the largest domestic consulting firms, with 200 clients, usually starts with a phone interview to evaluate the applicant. President Sally Lannin, a former placement officer at Stanford University, says she and her staff help students narrow their choices by identifying schools in their league. She also reviews application

LANNIN: Matching students with schools in their league

drafts and help clients brainstorm on essay topics. At an hour, a complete evaluation by MBA Strategies costs \$450 to \$750. The drill is similar at Kaplan Educational Centers, which opened admissions consulting in 1996. Trent Anderson, who heads the program, says he tries to match applicants with consultants who once worked at their chosen schools. At \$50, an online service, IvyEssays, sells a package of about 40 essays by applicants who have been accepted to your preferred school. The essays are supposed to be as examples only.

Such services, which seem to encourage cheating, could backfire. "If the school feels any part of the application is not the student's work, they are immediately disqualified," says Robert Alig, Wharton's director of admissions and financial aid.

Despite the shortage of consultants, many students who used them say all they really wanted was someone to hold their hand through the process. Take Lorin Decker, a 1998 graduate of Harvard B-school. Decker paid about \$300 for tips from Baron, a former member of the Harvard admissions committee who now works for Kaplan. "It was more of a confidence booster," Decker says. That might come in handy when you're in the tortuous process of applying for an MBA. Hala

What Admissions Consultants Offer

COMPANY	COST	COMMENTS
ACCEPTED.COM 310 392-1734/ www.accepted.com	\$325 for consulting, help with first essay	Phone consulting, online essay editing
IVYESSAYS 888 IVYESSAYS/ www.ivyessays.com	\$15. 1 essay set \$50. 5 sets	Sells previously accepted essays for use as examples
KAPLAN 800 KAPTEST www.kaplan.com/consulting/	\$899 for Kaplan students, \$1,199 for others	Matches you with former admissions committee member from your school of choice
MBA STRATEGIES 612 922-5991/ www.mbastrategies.com	\$150 per hour	Ex-placement officer and staff do phone evaluations and edit essays



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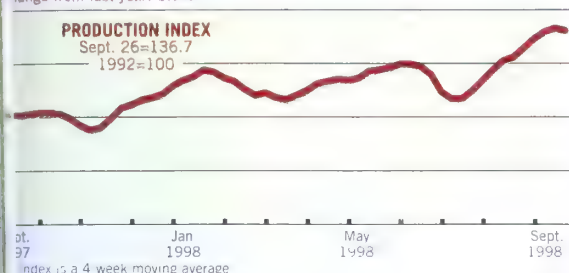
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16. Robert Bosch
GmbH
17. TIBCO
18. The Timken
Company
19. Toshiba America
Information
Systems, Inc.
20. USWEB
INTERNET ONLINE
Malaysia Airlines
PSA Corp Ltd
China External
Development Co.



Business Week Index

PRODUCTION INDEX

Change from last week: -0.1%
Change from last year: 5.5%



Production index slipped in the week ended Sept. 26. The unaveraged index was also down, by 0.4%, to 135.6 from 136.1 a week ago. After seasonal adjustment, auto and truck production dipped. General Motors announced plans to schedule heavy overtime through the fall to try to make up some of the 500,000 vehicles, and \$2-billion, lost during the strike. Output of crude oil and lumber were also down. Steel, coal, and rail-freight traffic posted small increases.

Index is a 4 week moving average

PRICING INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
PRICES (10/2) S&P 500	1002.60	1044.75	3.9
RATE BOND YIELD, Aaa (10/2)	6.12%	6.35%	-12.1
SUPPLY, M2 (9/21) billions	\$4,308.4	\$4,289.0r	8.5
CLAIMS, UNEMPLOYMENT (9/25) thous.	289	294r	-7.1
MORTGAGE APPLICATIONS, PURCHASE (10/2)	304.0	283.6	38.2
MORTGAGE APPLICATIONS, REFINANCE (10/2)	3,253.1	2,682.7	346.7

S: Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Assn. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
BANK FUNDS (10/6)	4.65%	5.44%	5.42%
COMMERCIAL PAPER (10/6) 3-month	5.10	5.08	5.50
SAVING DEPOSITS OF DEPOSIT (10/7) 3-month	5.31	5.25	5.61
MORTGAGE (10/2) 30-year	6.68	6.81	7.45
FIXED RATE MORTGAGE (10/2) one-year	5.60	5.65	5.65
LIBOR (10/2)	8.25	8.50	8.50

S: Federal Reserve, HSH Associates, Bloomberg Financial Markets

Data in the production indicators are seasonally adjusted in computing the BW index (chart); other components (estimated and not listed) include machinery and defense. 1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

THE WEEK AHEAD

SALES

Monday, Oct. 14, 8:30 a.m. EDT ▶ Retail sales likely increased by 0.4% in September, according to the median forecast of analysts surveyed by Standard & Poor's. Division of The McGraw-Hill Companies. Including purchases of motor vehicles, retail sales probably increased by 0.2% in August, overall store receipts rose 0.2%, and nonauto sales increased 0.2%.

PRICE INDEX

Tuesday, Oct. 15, 8:30 a.m. EDT ▶ Producer price of finished goods were probably up in September, after falling in August, says the S&P MMS forecast.

Excluding food and energy, core prices were probably down 0.1% last month, following a 0.1% dip in August.

BUSINESS INVENTORIES

Thursday, Oct. 15, 8:30 a.m. EDT ▶ Inventories held by manufacturers, wholesalers, and retailers probably grew by a small amount in August, after showing no growth since April. Factories have already reported a 0.2% rise in their stock levels. Business sales likely increased 0.3% in August, after falling 0.1% in July.

CONSUMER PRICE INDEX

Friday, Oct. 16, 8:30 a.m. EDT ▶ Consumer prices of all goods and services probably

rose 0.1% in September, says the median S&P MMS forecast. Excluding food and energy, core prices probably rose 0.2%. In August, the total price index and the core index each increased 0.2%.

INDUSTRIAL PRODUCTION

Friday, Oct. 16, 9:15 a.m. EDT ▶ Industrial output probably rose by 0.1% in September, after jumping 1.7% in August when auto production recovered sharply from the General Motors Corp. strike. The flat September reading is suggested by the weakness in the month's factory jobs and workweek. On average, industries probably used 81.5% of their capacity in September, down from 81.7% in August.

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (10/3) thous. of net tons	1,969	1,929#	-9.2
AUTOS (10/3) units	127,738	136,806r#	2.8
TRUCKS (10/3) units	130,515	138,411r#	-7.3
ELECTRIC POWER (10/3) millions of kilowatt-hrs.	67,849	68,881#	6.8
CRUDE-OIL REFINING (10/3) thous. of bbl./day	13,653	14,815#	-9.5
COAL (9/26) thous. of net tons	22,628#	22,087	5.5
LUMBER (9/26) millions of ft.	488.9#	490.4	1.9
RAIL FREIGHT (9/26) billions of ton-miles	27.6#	27.4	3.8

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WWPAl, SFPAl, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (10/7) \$/troy oz.	298.000	293.850	-10.4
STEEL SCRAP (10/6) #1 heavy, \$/ton	85.50	85.50	-37.8
COPPER (10/2) ¢/lb.	78.7	78.7	-19.9
ALUMINUM (10/2) ¢/lb.	63.5	63.5	-19.6
COTTON (10/2) strict low middling 1-1/16 in., ¢/lb.	69.95	70.90	0.5
OIL (10/6) \$/bbl.	15.30	15.81	-30.2
CRB FOODSTUFFS (10/6) 1967=100	222.04	225.10	-9.2
CRB RAW INDUSTRIALS (10/6) 1967=100	276.06	281.79	-17.4

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (10/7)	122.85	136.43	121.59
GERMAN MARK (10/7)	1.61	1.67	1.75
BRITISH POUND (10/7)	1.70	1.70	1.62
FRENCH FRANC (10/7)	5.40	5.60	5.89
ITALIAN LIRA (10/7)	1593.0	1651.0	1721.5
CANADIAN DOLLAR (10/7)	1.52	1.53	1.37
MEXICAN PESO (10/7)	10.180	10.190	7.754
TRADE-WEIGHTED DOLLAR INDEX (10/7)	106.6	110.9	105.4

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan

This Week, Online

Business Week presents frequent live conferences and chats on America Online—your opportunity to ask questions about timely topics.

Sunday

Learn how to market your Web site, in a BW Enterprise chat with Peter Meluso of online marketing agency i-traffic. **Oct. 11 9 p.m. EDT**

Tuesday

Investment issues women face: expert answers from Standard & Poor's analyst Susan Pevear, in an event co-hosted by BW and S&P Personal Wealth. **Oct. 13 4:30 p.m. EDT**

Thursday

International investments—should you or shouldn't you, with all the news of crisis? Ask Robert LaFleur, chief investment strategist for Northern Trust. **Oct. 15 9 p.m. EDT**

AOL keyword: BW Talk

Transcripts of all conferences are available for downloading from the BW Online area on AOL soon after each event.

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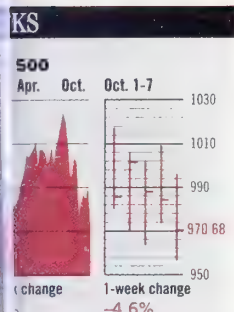
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Investment Figures of the Week



ENTARY
ek into the fourth quarter, market mayhem shows no abating. Even record-long-term interest rates did not deter equity investors. The dustrials looked like a strength, down only 1.3% week. The real damage e big technology stocks, eem finally to have fall-he bears. The NASDAQ ite, dominated by Mi-Intel, Cisco Systems, I Computer, dropped for the week. Looking the only bright spot was where stocks rallied and soared.

U.S. MARKETS	Latest	% change Week	% change Year
Dow Jones Industrials	7741.7	-1.3	-4.4
NASDAQ Combined Composite	1462.6	-13.7	-16.0
S&P MidCap 400	285.3	-7.1	-15.7
S&P SmallCap 600	133.7	-11.5	-30.3
S&P SuperComposite 1500	203.6	-5.0	-3.1

SECTORS	Latest	% change Week	% change Year
Bloomberg Information Age	324.5	-8.5	4.8
S&P Financials	96.3	-10.0	-17.3
S&P Utilities	266.6	4.3	29.9
PSE Technology	284.1	-11.2	-17.7

FOREIGN MARKETS	Latest	% change Week	% change Year
London (FT-SE 100)	4828.9	-4.7	-8.2
Frankfurt (DAX)	4087.8	-8.6	-6.0
Tokyo (NIKKEI 225)	13,825.6	3.1	-21.5
Hong Kong (Hang Seng)	7744.7	-1.8	-47.8
Toronto (TSE 300)	5463.4	-2.7	-24.1
Mexico City (IPC)	3375.4	-5.4	-36.3

FUNDAMENTALS	Latest	Week ago	Year ago
S&P 500 Dividend Yield	1.61 %	1.52 %	1.54 %
S&P 500 P/E Ratio (Last 12 mos.)	23.7	25.0	24.5
S&P 500 P/E Ratio (Next 12 mos.)*	19.0	20.3	19.5
First Call Earnings Surprise*	9.05 %	1.90 %	4.88 %

TECHNICAL INDICATORS	Latest	Week ago	Reading
S&P 500 200-day average	1066.6	1065.8	Negative
Stocks above 200-day average	19.0 %	22.0 %	Positive
Options: Put/call ratio	0.80	0.57	Positive
Insiders: Vickers Sell/buy ratio	0.62	0.65	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

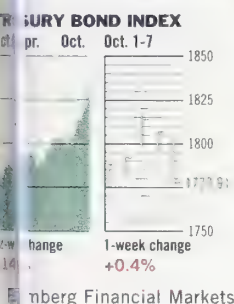
BEST-PERFORMING GROUPS	Last month %	Last 12 months %
Gold Mining	39.5	Drug Chains 40.4
Regional Telephone Cos.	19.0	Regional Telephone Cos. 36.8
Natural Gas	18.4	Genl. Merchandise Chains 36.3
Instrumentation	17.0	Long-Dist. Telecomms. 33.3
Tobacco	16.2	Electric Companies 32.9

WORST-PERFORMING GROUPS	Last month %	Last 12 months %
Machine Tools	-25.6	Oil & Gas Drilling -67.3
Communications Equip.	-25.1	Leisure Time -52.8
Invest. Banking/Bkrge.	-24.8	Metals -49.6
Hotels & Motels	-24.7	Oil-Well Equip. & Svcs. -48.1
Metal & Glass Containers	-21.1	Machine Tools -45.6

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness	Price	1-month change
Citicorp	85	-13 1/16
Intel	79 7/8	-2 9/32
IBM	119 1/4	-6 1/16
BankAmerica	60 1/8	-3 1/4
Pfizer	89 3/8	-11 7/16
Procter & Gamble	74 1/4	-5 3/8
Decline ahead? Stocks with most significant selling on price strength	Price	1-month change
Qwest Communications	31 3/16	1/8
Starbucks	36 15/16	3 1/16
Adobe Systems	32	6 5/16
Goodyear Tire & Rubber	50 13/16	1 1/16
PepsiCo	33 3/8	1 1/16
Iridium World Communications-A	34 5/8	1/4

EST RATES



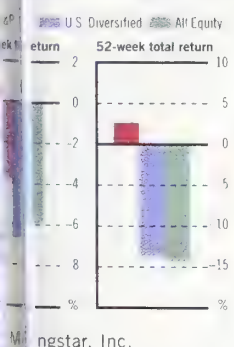
KEY RATES	Latest week %	Week ago %	Year ago %
MONEY MARKET FUNDS	5.02	5.05	5.14
90-DAY TREASURY BILLS	4.12	4.37	5.08
6-MONTH BANK CDS	4.72	4.82	5.18
1-YEAR TREASURY BILLS	4.23	4.41	5.42
10-YEAR TREASURY NOTES	4.40	4.44	6.08
30-YEAR TREASURY BONDS	4.86	4.98	6.36
LONG-TERM AA INDUSTRIALS	5.92	6.03	6.85
LONG-TERM BBB INDUSTRIALS	6.77	6.79	7.21
LONG-TERM AA TELEPHONES	6.38	6.45	7.16

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond Latest week	Last week	30-yr. bond Latest week	Last week
GENERAL OBLIGATIONS	3.95%	4.14%	4.63%	4.78%
PERCENT OF TREASURIES	89.99	93.67	95.28	96.04
TAXABLE EQUIVALENT	5.72	6.00	6.71	6.93
INSURED REVENUE BONDS	4.08	4.29	4.83	4.97
PERCENT OF TREASURIES	92.95	97.36	99.39	100.06
TAXABLE EQUIVALENT	5.91	6.22	7.00	7.20

L FUNDS



WEAK MEDICINE FOR A RAGING CRISIS

Remember those fearful stories your parents and grandparents told about the Depression, about how bad it was and how it scarred their lives forever? Remember thinking, how could leaders have allowed such a catastrophe to happen? Well, it's now easier to understand. Look around. A currency crisis in a small country—Thailand—triggers an unexpected global economic crisis, spreading poverty across continents with fearsome speed. A year later, well-meaning policymakers fumble their best chance to stop a tide of deflationary recession. Instead of forging a bold plan to relive the global economy, they demonstrated only timidity at this year's annual International Monetary Fund conference. They failed to put a floor fast enough under a rapidly deteriorating global economy.

True, the spin out of the IMF conference is that a series of gradual steps will bring the world economy back from the abyss: a \$30 billion aid package for Brazil, if Brazil can find the political will to cut its budget; a line of credit to countries with sound economies under speculative attack; a "bail-in" plan to force banks to take a haircut on loans before the IMF puts in new money; a cautious approval of capital controls on incoming short-term hot money. All positive moves, certainly (page 36).

A FAILURE OF LEADERSHIP

The best news, however, comes from Tokyo, not Washington, where the government of Prime Minister Keizo Obuchi may have circumvented opposition in Parliament for legislation to finally bail out Japan's insolvent banks. If Japan pumps billions of dollars into its banking system and it starts lending again, the country's eight-year economic decline can be arrested. Package this bit of optimism with that coming out of the IMF, and the beginnings of a piecemeal effort to battle global deflation can be seen to be falling into place. Maybe. So far, though, gradualism has done little to reverse the global decline.

Confidence already is eroding in the U.S. Last spring's stock market euphoria is becoming this fall's concern. With the stock market down nearly 20% from its peak, consumers are showing signs of curbing back-to-school purchases. Banks suddenly are tightening up their lending standards. Excessive loans to a highly leveraged, secretive hedge fund raise questions about the basic health of the banking system itself. Corporate earnings are slipping, and a profits recession is setting in; layoffs are rising fast, and job growth is slowing; the yield curve is flat and suggests recession. Capital spending can turn on a dime, and if it starts to decline, the investment-led expansion of the past eight years can quickly come to a halt.

There is a palpable feeling of markets seizing up and a nation starting to hunker down. The failure of leadership is taking its toll. In the U.S., the Federal Reserve proffers a begrudging interest-rate cut and warns not to count on more anytime soon at a time when the global economy needs mas-

sive monetary easing. Congress continues its partisan war delaying funding for the IMF, even though the institution has capitulated to its demands for less austerity and more transparency. Europe remains obsessed with its inward-looking euro. Japan continues its economic free fall. And it blames hedge funds, banks, Westerners—anyone but its cronies and corrupt practices.

The solution to the current economic crisis is clear enough. Restore demand. The world's most important source of demand growth, the Asian consumer, has been driven from global markets and forced to retreat back into local economies. Devaluations of 30%, stock market declines of 50%, and unemployment have produced a monumental case of downward mobility. Nothing like it has been seen since the Depression. Instead of buying European cars, American computers, and Japanese electronics, Thais, Indonesians, and Koreans are purchasing homegrown rice, batik shirts, and local medicines. In that way, Asia's poverty can impoverish the world.

To restore demand, a deal with the heft and significance of the Smithsonian Agreement in 1973 and the Plaza Accords in 1985 is needed. They were transformative events, remaking the global currency system. They showed that gradualism does not do. A global commitment by the industrial nations to the tide of deflationary recession is needed. The deal would involve three steps. A write-down and workout of emerging market debt, brokered by the U.S. Treasury or the IMF, is the most important. Most of the debt is private, owed to European and American banks. Today, the money earned on trade surpluses goes to debt repayment, not domestic growth in Thailand, Indonesia, or Korea. Relief from the debt hang would release cash for export financing and consumption.

A coordinated easing of policy by the Group of Seven is critical as well. The inability of G-7 leaders at the IMF meeting in Washington to agree to a highly publicized, coordinated interest-rate cut is a lost chance. Japan, Canada, Korea, Spain, Malaysia, China, and Thailand have made small cuts. Britain appears poised to do so, but Germany remains undecided. Gradualism may help some. But only a synchronized cut can send the powerful signal that is needed.

TIME TO CUT TAXES

A commitment is needed to fiscal policies that stimulate demand. That means the fierce commitment to fiscal rectitude that has dominated policy over the past decade should be examined. Tax cuts loom increasingly important all over the world. The U.S., with its large budget surplus, must begin work of a significant tax cut in the year ahead.

From the start, policymakers have misjudged the deflationary typhoon blowing out of Asia. It has taken nearly a year of failure to abandon old orthodoxies. The fragile gradualist approach taken by world leaders in Washington is unlikely to turn the tide. A grand design is needed to keep the crisis of confidence from becoming a crisis of capitalism.

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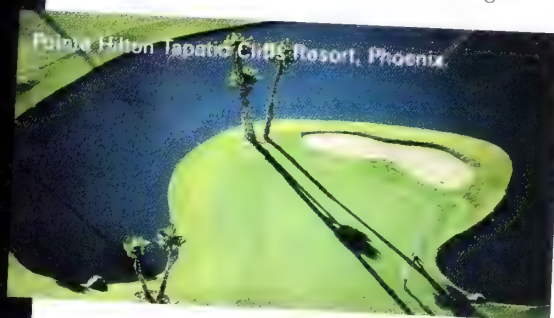
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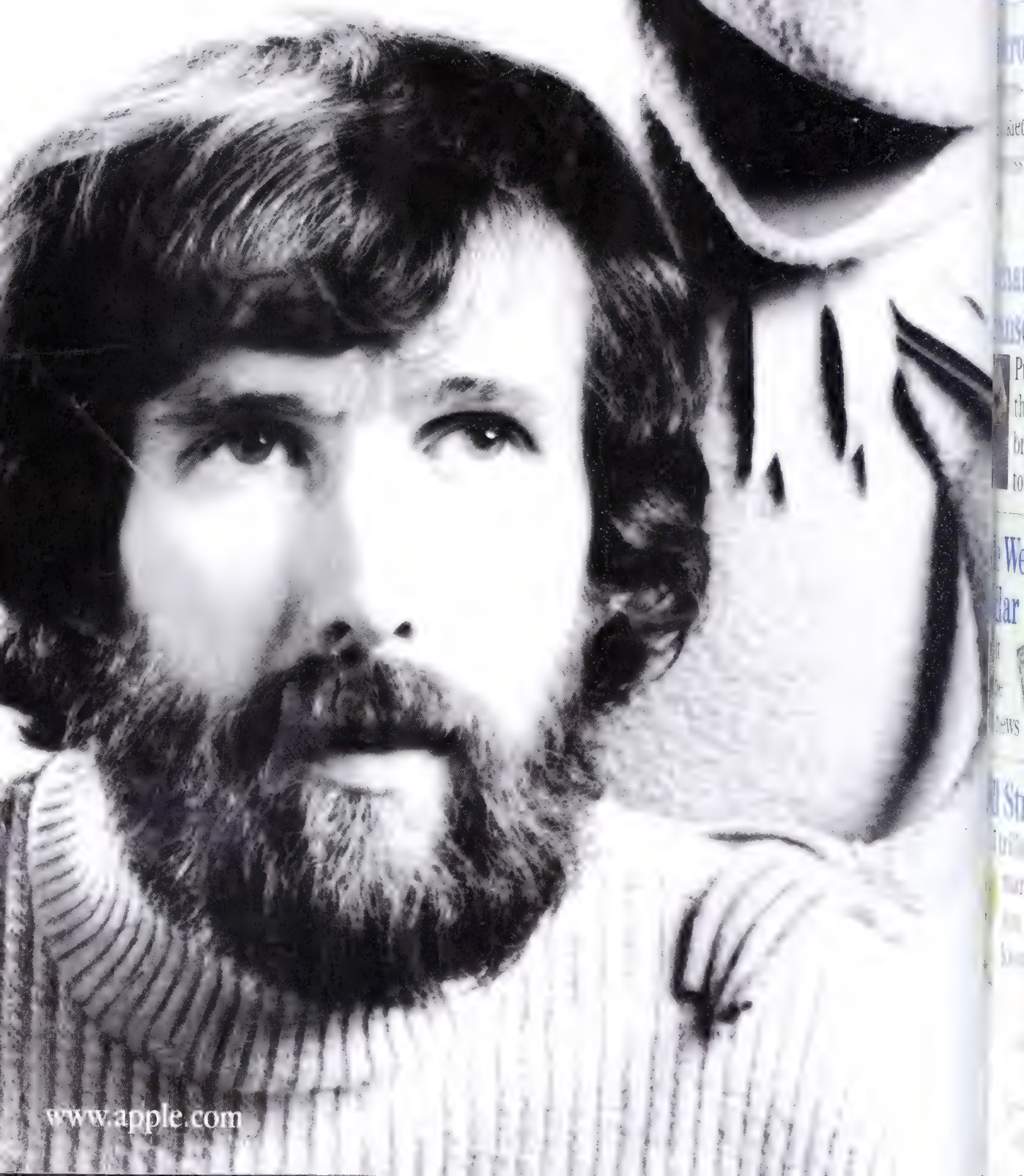


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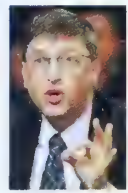
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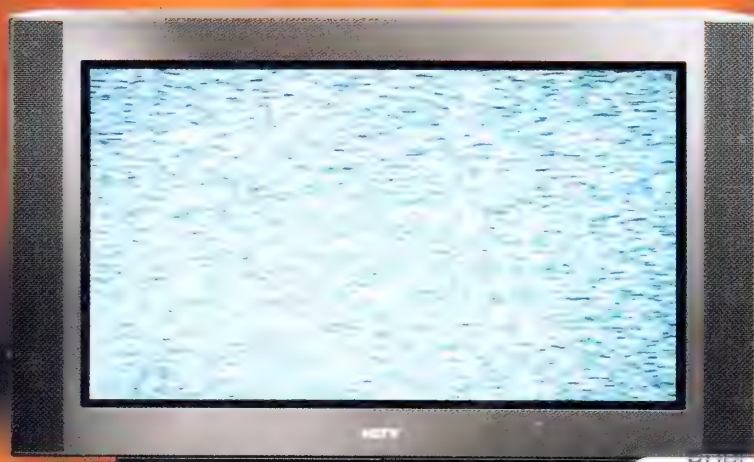
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HDTV broadcasts start
November 1. Is anyone ready?

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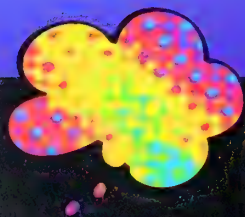


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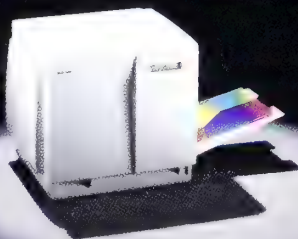
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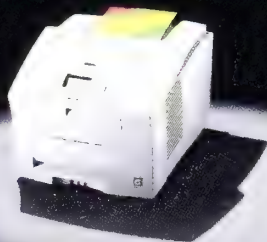
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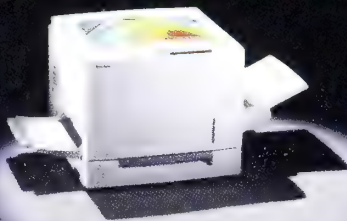
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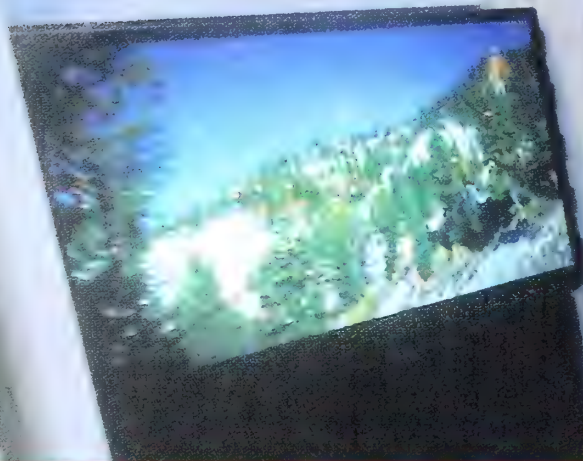
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Panasonic HDTV PROJECTION MONITOR



BusinessWeek

OCTOBER 26, 1998



Cover Story

144 DIGITAL D-DAY

The TV revolution is at hand: 42 stations will transmit the first digital broadcasts on Nov. 1—the biggest change since the advent of color. In the long term, it will turn the high-tech world upside down. But in the short run, no one is quite sure what to make of it

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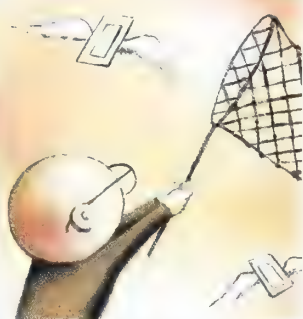
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He could unseat Senator Barbara Boxer of California, yet nobody is talking about his Donorgate connection

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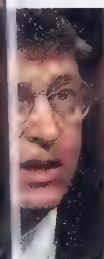
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Up Front

EDITED BY JOAN OLECK

MEDIA MANIA

THE FREE LUNCH PETERS OUT

JOURNALISTS ARE RENOWNED for swarming freebie buffets. Imagine learning, then, that one of their longest-running free lunches—served by Bloomberg—is coming to an end. Since 1990, the company has been feeding newspapers and magazines its data and news gratis, provided the outlets credit Bloomberg.

The move helped CEO Michael Bloomberg build a brand name, which proved invaluable for pushing his main product, the \$1,225-a-month data terminal that 100,000 financial-industry types now use. That's up from 10,000 users eight years ago. So even



BLOOMBERG:
Time to pay up

though the move would earn only \$3 million a year if all the media organizations, including BUSINESS WEEK, paid up, the 56-year-old media mogul wants a message to get out. "We're the news wire of record in the U.S.," Bloomberg says. "Let's then charge and show it."

Media outlets are pondering whether to cough up the \$750 to \$2,000 monthly fee.

This may be a chance for Bridge Information Systems, which is offering its data free. But some users can't let go. "We're hooked," says George Gombossy, *Hartford Courant* business editor. Now, it's Mike Bloomberg's job to start reel-ing them in.

Dennis Berman

UP, UP, AND AWAY

A TICKET FEE HIKE: WILL IT FLY?

CONGRESS MAY HAVE GUTTED Federal Aviation Administration funding but, hey, it also christened 1998 the Year of Aviation. So the Airports



\$1 MORE? Bigger airports needed

Council International is celebrating. The ACI is launching a \$250 million campaign to lobby Congress for a \$1 increase in the \$3 ticket fee to fund airport improvements.

Big airlines hate the fee and got Congress to kill it. "We don't want to be tax col-

lectors for projects we can't control," says Edward Merlis of the Air Transport Assn.

There's more to it, claims Jeffrey Goodell, an ACI lobbyist. He says the ATA's real problem is fear of competition. New terminals could give new entrants a chance to crack the hub dominance of big carriers. Still, the ATA might not win the battle this time. The ACI is already drawing support from municipalities and airport contractors with a video tutorial on how to lobby Congress, among other things. Timing is critical: The National Business Travel Assn., a corporate-

travel group that backs the ACI, says airport use will more than double, to 800 million passengers, by 2005. At that rate, says NBTA Director Norman Sherlock, that extra buck could be too little, too late. Dennis Blank and Lorraine Woellert

TALK SHOW "We're down to splitting infinitives."

—House Majority Leader Dick Armey (R-Tex.), observing that a deal on IMF funding is imminent

SOOTHSAYERS

A FAMOUS BEAR SEES HONEY AHEAD

REMEMBER ELAINE GARZARELLI? Two years ago, the investment strategist—who made her name by turning bearish a month before the 1987 crash—yelled "sell!" at Dow 5400. Six months later and 1200 points higher, she turned bullish. But too late: Her bad call took Garzarelli out of the guru game. Market mavens and the media chose Abby Joseph Cohen of Goldman Sachs and Ralph Acampora of Prudential Securities as their favored seers.

Now, the onetime Lehman Brothers superstar is telling clients to load up. The indicators she watches are 75%



GARZARELLI:
11,300 Dow?

positive: "That's what you see at market bottoms," Garzarelli says. In fact, those indicators are at their most bullish since 1994, when the Dow was below 4000.

Garzarelli predicts deflationary forces will push interest rates lower and continue to depress corporate earnings. Still, she says, pressure on profits will ease during 1999's third quarter. Anticipating that, the market will rally. Garzarelli's goal: 1400 on the S&P 500 or 11,300 on the Dow Jones, within 12 to 18 months. Cohen, meanwhile, has forecast 1200 to 1250 for the S&P in 1999; a bearish Acampora points to Dow 6700. If Garzarelli proves more on target, the word may once again mean markets. Jeffrey Laderman

NAME GAME

DOUBLE VIAGRA WITH NUTS, PLEASE

AH, AMORE! THE COUNTRY famed for Latin lovers and gondolas, Chianti and Sophia Loren has added something new to its passion playlist: *Viagra gelato*.

First things first: There's no Viagra in it. The ice-cream flavors of neon-blue "Viagra Man" and hot-pink "Viagra Lady" merely pay homage to the drug. The *gelato* is made with natural coloring and leaves a cinnamon aftertaste.

Entrepreneurs Mirko and Marco Mariotti say their dad got the idea just before opening Zio Ciro ice cream shop off Rome's Piazza Navona. Now, the brothers plan a shop near the Pantheon, and they hope to market the ice

cream elsewhere in the country.

Meanwhile, the *gelatos* are attracting customers—and serious stares. "I'm intrigued to try it, but I don't want to take a gamble," said Darnell Kennelly, on vacation from London. His wife's only comment was that she found the ice cream's color a turn-off. No matter. *Gelato* lovers says Mirko Mariotti, have been scooping the stuff up

though "Viagra Man" has outsold "Viagra Lady." Perhaps psychology is at work here, suggested the husband of some Mario's Marco: "A woman tried the *Viagra Lady* and jumped on my brother." Mirko: "That's before she ate it."

Monica Laderman



ARE THEY GOING THE WAY OF THE DODO BIRD?



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Up Front

INFORMATION AGE

ACER SCALES BACK ITS ASPIRATIONS

ACER GROUP IS THE WORLD'S third-largest personal-computer maker, big in Asia and emerging markets. But the Taiwan-based company has stumbled badly in the U.S.: It now appears doomed to being a niche player, selling sub-\$1,000 computers, mostly in Wal-Mart and Sears Roebuck stores.

Beset by weak marketing and management turmoil, Acer's U.S. market share has slipped from 5.4% in late 1995—when the company had a breakthrough with its sleek Aspire PC—to just 3.2% now, says International Data.

Acer's U.S. operations lost

\$75 million last year and will likely lose \$50 million more in 1998. It has also slashed staff devoted to the consumer market, admitting it can't compete head-on with Dell Computer or Compaq Computer. So Acer will focus on sub-\$1,000 PCs for home use and systems for schools, governments, and businesses. Critics call those markets saturated. "Why would a customer buy an Acer?" asks an executive at a major U.S. PC retailer. "It's a non-brand."

Acer Group Chairman Stan Shih, however, sounds determined. "Our resources in the U.S. and Europe are limited," he says. "We have to focus on niches."

Hey, even a feeble toehold beats none. *Jonathan Moore and Peter Burrows*



Acer



BUSINESS SPEAK

CLEAN IT UP—OR ELSE

"THE GREAT ENEMY OF CLEAR language is insincerity," George Orwell wrote. So imagine the suspicions aroused by this Federated Investors prospectus: "Redemptions will be processed in a manner intended to maximize the amount of redemption which will not be subject to a contingent deferred sales charge." Say what?

Mother-tongue abuse has often cost companies customers. Now, it may cost them cash. On Oct. 1, the Securities & Exchange Commission began requiring that prospectuses comply with a section of its plain-English regulations, or risk delaying an offering. That's a boon to consultants such as Siegel & Gale, based in New York.

Vice-president Irene Etzkorn says her language-challenged clients have included Prudential and American Century. She adds, of their financialese: "It's absolutely impenetrable. We have two lawyers on staff who are plain-English writers, and even they have not understood some of the passages." That Federated gobbledygook, for instance, was reborn as a chart that shows a mutual fund's back-end sales fees. Next? The Federal Communications Commission has a similar rule pending for phone bills. □

DRAWN & QUARTERED



THE DEFENDERS

GENERAL DYNAMICS PACKS A PAYLOAD

MOST AEROSPACE/DEFENSE industry stocks look as if they've been hit by cruise missiles. But not high-flying General Dynamics. While other defense contractors' shares have stagnated or plummeted, GD's shares are up 21% since May, to a recent 51.

Why the stellar performance? "The flight to quality," jokes GD CEO Nicholas Chabreja. Actually, GD, which makes ships, submarines, and tanks, was long overlooked by Wall Street. But its early 1990s divestiture of assets and its savvy acquisitions since then have paid off. Purchases of info-tech firms, for instance, now account for about 15% of GD's revenues, up from

0% a year ago. At the same time, GD's basic business remains strong: It just won a share of a \$4.2 billion Na submarine contract.

Last year GD said it would double its 1996 revenues to \$3.6 billion in five years. No Chabreja calls that forecast "conservative," and the record shows GD has paraded before Wall Street seem to have succeeded. Notes defense expert Loren Thompson of the Lexington Institute think tank

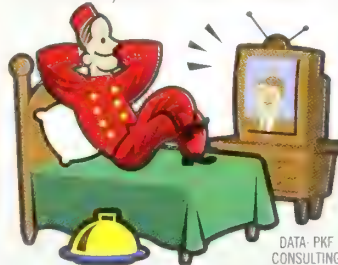
"Boeing makes planes, Raytheon makes missiles, GD makes money." *Sam Crock*



CHABREJA

THE BIG PICTURE

LOTS OF ROOM AT THE INN Thanks to a flurry of hotel construction, hotel occupancy rates nationwide are expected to drop this year for the first time since 1991. Expect a further decline in 1999. But unless the economy weakens, room rates could hold steady.



MARKETS WITH LARGEST PROJECTED OCCUPANCY DECLINES

Orange County, Calif.	-8.2
Salt Lake City	-7.8
Nashville	-7.6
Portland, Ore.	-7.5
Orlando	-6.9
National	-1.5

DATA: PKF CONSULTING

FOOTNOTES U.S. workers who say their organization has a mission statement: 70%; who know what's in it: 41%



Delta Air Lines

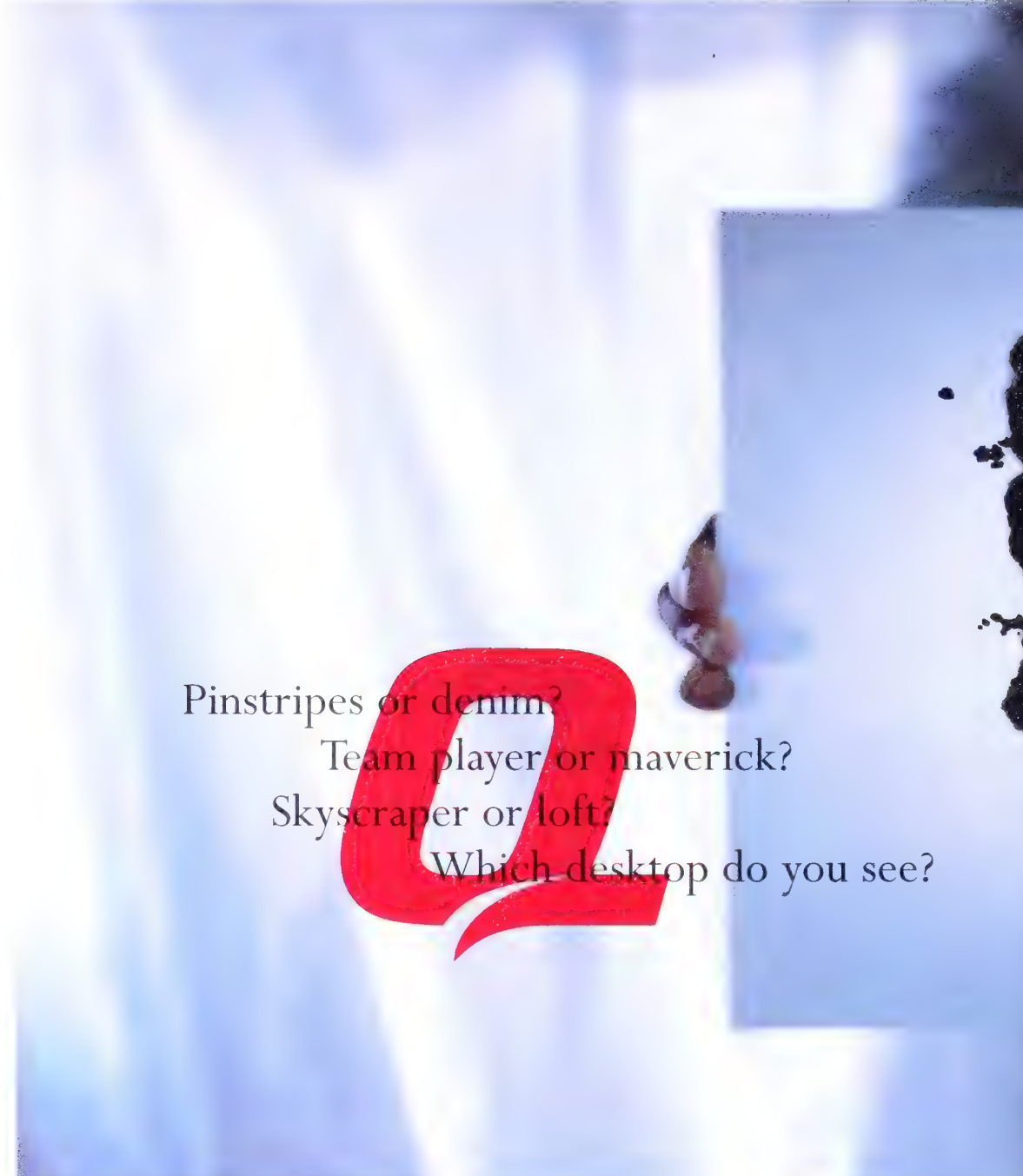
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MICROSOFT ON TRIAL: AN INVITATION

We're calling it "the best legal show in town." On Oct. 19, in Washington, D.C., opening arguments in *U.S. vs. Microsoft* are scheduled to begin. The most important business case in decades, it is certain to set the rules for competition in the Information Age.

We plan to keep you on top of the landmark antitrust case with news and analysis in the magazine. In addition, BUSINESS WEEK is joining with Court tv, the 24-hour cable-tv network. We'll supply daily trial reports on the World Wide Web as well as regular updates on Court tv. We will also co-produce *Microsoft on Trial*, a program anchored by Court tv's June Grasso, shown every Thursday evening at 7 p.m., while the trial lasts.

A panel of BUSINESS WEEK reporters will lead the effort, including Susan B. Garland, who covers the Justice Dept., Legal Affairs Editor Mike France, Software Editor Amy Cortese, and Steve Hamm, who reports on Microsoft from Silicon Valley. "I've never seen people get so emotional over a business issue," says Garland, who will be at the trial daily. "It's about a business that has become a symbol of American success." For ongoing coverage, go to www.businessweek.com or www.courtstv.com. We don't want you to miss a minute of it.

Stephen B. Shepard

Editor-in-Chief

CPAS: WHO'S WATCHING THE WATCHERS?

Thanks for a substantial, well-documented, and useful article—"Who can you trust?" (Cover Story, Oct. 5). You offer a range of specific, down-to-earth suggestions, and I would hope to see some of them materialize.

Two additional proposals:

1. Fees to investment bankers for arranging unions should be paid over time, maybe five years or more after the acquisition has taken place, and be linked to real performance over that period.
2. Analysts, investment bankers, and mergers-and-acquisitions brokers should complement their due-diligence process with business analysis systems that take into account the important threats and assets that are not reflected in account-

ing. Such systems, well-tested, exist. Hans V. A. Johnsson, Old Greenwich, Conn.

The certified public accountants who audit these rogue corporations know exactly what is going on. The supposed unbiased and independent CPAs have made a conscious decision to put the stamp of approval on questionable and devious accounting practices. CPAs hired by—paid by—the corporations they audit. CPA firms work very hard to get and keep their audit clients. This is a terrible tug of war in every firm between requiring a client to be forthright and truthful in their financial reports and keeping the client and the lucrative fees. It appears to me that too often money wins over honesty. Generally accepted accounting principles

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DIRECTIONS & CLARIFICATIONS

"Hard-driving boss" (People, Oct. 5), on
 lkswagen CEO Ferdinand Piëch, we report-
 "Industry execs whisper that he [Piëch]
 expecting his 14th child—and not with his
 fe." In an attempt to confirm this infor-
 mation, which was volunteered by industry
 rces, we had contacted Dr. Piëch and
 kswagen but unfortunately did not hear
 ck from them before the magazine went to
 ss. According to new information we have
 ce obtained from Dr. Piëch, he is in fact
 expecting a 14th child. BUSINESS WEEK
 ologizes to Dr. Piëch and his wife, Ursula.

"Bad banks: Why Japan's pols are para-
 ed" (International Business, Oct. 5), the
 ng Sumitomo bank was named. The arti-
 should have cited Sumitomo Trust &
 king Co.

The GMATs: To prep or not to prep" (Per-
 al Business, Oct. 19), we should have not-
 that BUSINESS WEEK has a branding and
 keting relationship with Princeton Review.

s (GAAP) may not have specific rules
 dealing with today's gigantic
 acting shenanigans, but one GAAP re-
 ment, apparently the hardest of all
 deal with, will never change: to tell
 ruth, the whole truth, and nothing
 the truth. Your last sentence—
 at we need is more integrity—in-
 ty in managers and integrity in
 numbers"—is incomplete. What
 eed also is integrity in their CPAs.

Bernard B. Kamoroff, CPA
 Willits, Calif.

ur article does an excellent job of
 ssing the incentive faced by execu-
 auditors, and analysts as they pre-
 or evaluate financial statements.
 group, though, deserves further at-
 n—audit committee members. The
 e calls for more audit committees
 ting of "truly independent business
 e." What we really need are more
 ittees consisting of "truly indepen-
 accounting and auditing experts."
 like many other board functions,
 idit committee work is often tech-
 ic for it deals with accounting and
 ng standards. You wouldn't let a
 rtorney oversee legal compliance or
 physician oversee medical issues, so
 ho we often have non-accountants
 eeing the financial reporting?
 ny boards try to turn good direc-
 nto good audit committee mem-
 er. But without technical training in
 ating and auditing, this can be dif-
 to accomplish. I would prefer to
 ore boards add accounting and au-
 experts to the audit committee

and then help these individuals to be-
 come good all-around directors.

Dana R. Hermanson
 Director of Research
 Corporate Governance Center
 Kennesaw State University
 Kennesaw, Ga.

KAPLAN'S GMAT PROGRAM: FOCUSED AND SUCCESSFUL

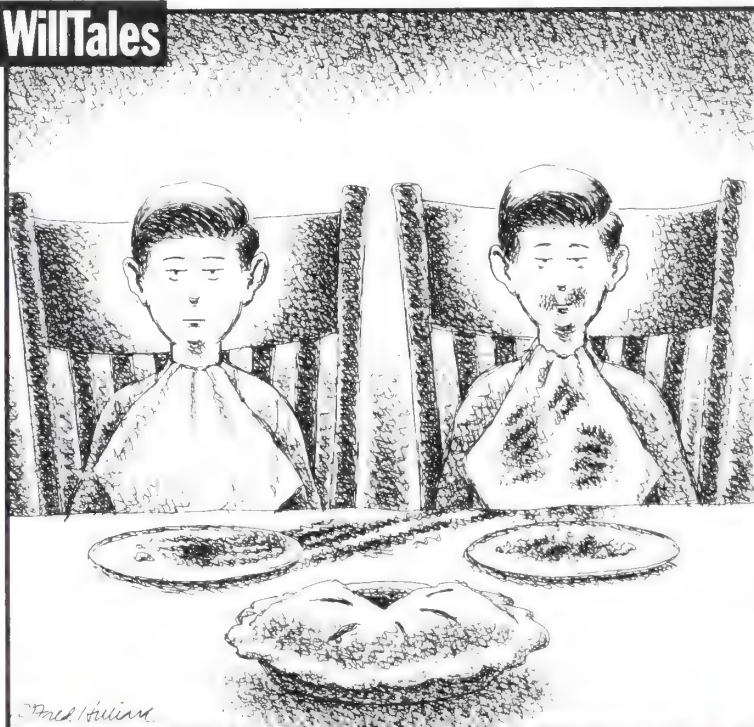
Your "Best business schools" issue
 (Cover Story, Oct. 19) promoted an eval-

uation of GMAT prep courses. We wish
 you had actually done so. We invited
 your reporter to come into our classes to
 see for himself why Kaplan is the largest
 and fastest-growing GMAT program, with
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He would have found a focused pro-
 gram that respects students' time and
 intelligence, with highly engaging teach-
 ers and lots of opportunities to practice
 in the new computer test format. Statis-
 tically, getting into business school is
 harder than it has ever been. Kaplan

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Readers Report

has been so successful because we help busy students get the scores and advice they need to overcome the high hurdle that business school admission presents.

Maybe some of this didn't make it into the article because our GMAT software has a 90% market share, which doesn't leave much room for the GMAT software BUSINESS WEEK co-brands with one of our competitors. That somehow didn't get disclosed.

Jonathan N. Grayer
Chief Executive
Kaplan Educational Centers
New York

Editors' note: We regret that the story did not mention that BUSINESS WEEK and Princeton Review have a co-branding and marketing relationship. But our story was based on what more than 2,000 recent graduates at 61 top B-schools told us in a survey, plus more than 20 additional interviews. And we did send a reporter to visit a Kaplan class.

WHEN 'MARKET-NEUTRAL' IS ANYTHING BUT

Let me congratulate you on "Failed wizards of Wall Street" (Cover Story, Sept. 21). You do a service to the industry to expose the flagrant misuse of the term "market-neutral" to describe practices that are anything but. Huge gains and losses are the province of directional players, not market-neutral strategists.

In your analysis of the catastrophic losses that occurred in August, 1998, you point out that historical relationships underlie most computer models. Unfortunately, this is true. Clearly, computers can't be the problem; they are just dumb tools. The fatal flaw is the purely statistical nature of these models. Correlation does not imply causality. Without under-

standing what causes relationships to exist, no amount of computer-parsed historical data will suffice to protect managers and their clients from a 20-standard-deviation event. The term "market-neutral" should not be used to describe dressed up directional plays.

You point out that managers who really run market-neutral portfolios actually made money, and this is laudable. I believe that market neutrality is the future of investment management and that, one day, financial historians will wonder why investors ever made "informed" directional bets. It would be a step backwards to condemn the genuine progress that has been made in investment management because a few highly visible managers have employed mistaken concepts and thus slipped on a very steep learning curve.

Leif H. Olsen
New Canaan, Conn.

WHERE THE BRONX BOMBERS ARE REALLY BOMBING

In "The money machine" (Sports Business, Sept. 28), you accurately reported that George M. Steinbrenner III blames the New York Yankees' relatively low attendance on Yankee Stadium. In fact, lackluster marketing is partly to blame. Last June, I called the Yankees ticket office to purchase tickets for Old Timer's Day. I was subjected to a long taped message providing intricate and then-obsolete details concerning every promotional event starting with the beginning of the season, which was more than two months prior to my call. It was nearly 10 minutes before the tape contained any information about games yet to be played. With such an amateurish sales effort, it is no wonder the Yankees are attendance underachievers. Abandoning Yankee Stadium is not the answer. The answer is better marketing.

Andrew Spark
Sarasota, Fla.

SLAMMING A SPAMMER CAN GET OUT OF HAND

In "Reconciling E-commerce and privacy" (Editorials, Oct. 5), you argue for "opt-out" in Internet marketing. A fine concept, if the people doing the marketing are willing to comply. But that often isn't the case. The problem with opt-out requirements is that by sending an opt-out message to a marketer, or worse a "spammer," you merely make your E-mail address more valuable. By responding, you are telling the sender your address is valid and that you read

your E-mail. While that spammer may not send to you again, he can sell you address to someone who will.

The key to the future of E-commerce is in finding and supporting responsible methods of marketing that are user friendly and that users can trust. To do that, advertisers have to stop looking at Internet users as targets and start developing them as partners in the marketing process.

Ian Oxman, President
ChooseYourMail.com
Chicago

GIVE NIPPON CREDIT SOME CREDIT

Regarding "Bad banks: Why Japanese banks are paralyzed," (International Business, Oct. 5), your article says Nippon Credit Bank (NCB) "owes nine insurance companies some \$1.5 billion and needs to reschedule payment." NCB offered to life insurance companies and casualty insurance companies—22 in all—an option for prepayment on the existing subordinate loans and commitment on new subordinate loans, only in a small amount than the existing ones. Since the option has been accepted by most companies, NCB already prepaid some loans and restructured the capital. It should be clear that there was never a necessity on NCB's side to "reschedule."

NCB's recent achievements as a result of strict restructuring, such as limited Asian exposure, completion of nonbank subsidiary problems, etc., are well received in the stock market.

Tadashi Umi
Senior Manager, Public Relations
Nippon Credit Bank Ltd.
Tokyo

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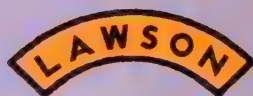
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fig. 1

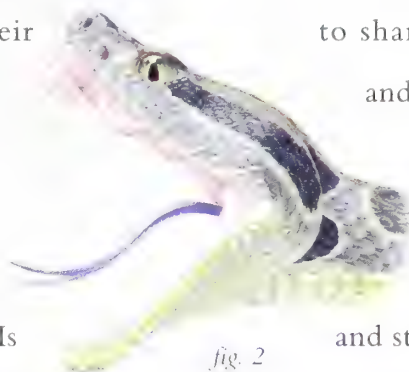


fig. 2

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THE BALTIMORE CASE

A Trial of Politics, Science, and Character

By Daniel J. Kevles

W. W. Norton • 509pp • \$29.95

WITCH HUNT IN THE GROVES OF ACADEME

In 1986, David Baltimore, a Nobel prize-winning biologist at the Massachusetts Institute of Technology, was working on a vitally important question concerning the human immune system: How does it build defenses against microbes it has never seen before? Baltimore was widely admired as a brilliant scientist and an influential teacher. He was also known to be arrogant and uncompromising. "David's strong point is not humility.... He has an enormous amount of hubris, but I know few people more entitled to it," one scientist said.

As events began to unfold in May, 1986, Baltimore's hubris would intensify a scientific dispute that would eventually lead to a bitter rift with some of his oldest and closest friends, cost him one of the nation's most prestigious science posts, and threaten to destroy his career. Before it was over, the Baltimore case, as it came to be known, would become the focus of a punishing, bare-knuckled congressional investigation and spark a criminal investigation. A reprehensible episode in the history of American science, the case dragged on for 10 years before coming to an abrupt and surprising end.

As Daniel J. Kevles recounts in *The Baltimore Case*, the story began with Margot O'Toole, a young scientist doing research in the lab of Thereza Imanishi-Kari, one of Baltimore's MIT colleagues. Imanishi-Kari, Baltimore, and others had published a paper in the journal *Cell* with unexpected findings on how the immune system rearranges itself to produce antibodies against a microbial invader it is seeing for the first time. O'Toole was trying without success to repeat aspects of the research when she stumbled across data scrawled in a laboratory notebook that suggested to her the *Cell* study was wrong. Before long, O'Toole came to believe that the

errors were deliberate. What had begun as a question of error became an allegation of fraud and scientific misconduct directed at Imanishi-Kari.

The charges were examined by researchers at MIT and at Tufts University, where Imanishi-Kari had been offered a job as an assistant professor. In the course of those discussions, Imanishi-Kari discovered that there were several mistakes in the paper, although none of them affected its conclusions. Baltimore suggested experiments that might be done to settle the questions. The case then caught the attention of the NIH, which funded much of Baltimore's research. O'Toole continued to press for a fuller investigation. Two self-styled fraud-busters at the NIH, Ned Feder and Walter W. Stewart, took the matter to Capitol Hill, where they discussed it with aides to Representative John D. Dingell (D-Mich.), a pugnacious righter of wrongs who relished uncovering abuses involving taxpayers' money. Baltimore soon found himself defending Imanishi-Kari and her research in the naked light of a full-scale Dingell investigation. Dingell referred the case to the U.S. Attorney in Maryland, and Imanishi-Kari faced the possibility of criminal charges.

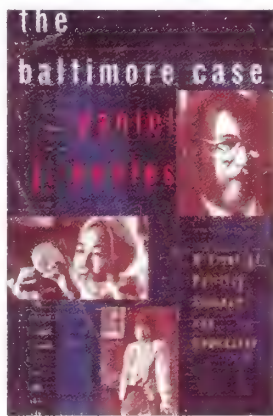
In *The Baltimore Case*, Kevles, a historian at the California Institute of Technology, also becomes a righter of wrongs. He shows, in unrelenting detail, how the case spun out of control, turning a dispute over minor errors and differing interpretations into a modern-day witch hunt.

Kevles spreads the blame around. A scorching NIH condemnation of Imanishi-Kari and Baltimore was based on

innuendo and hearsay, Kevles says. Furthermore, Imanishi-Kari and Baltimore had none of the due-process protection they would have had in a court of law. Dingell's investigators, Kevles says, tainted the investigation with press leaks. And the press simply regurgitated what it was handed, without probing the merits of the case.

In the midst of all of this, Baltimore was named president of Rockefeller University in New York, one of the nation's leading research universities. A little more than a year later, however, he was forced to resign when he lost the support of a crucial segment of the senior faculty. Throughout the 10-year ordeal, Kevles notes, Baltimore received almost no support from his scientific colleagues. Some of his closest friends turned against him, denouncing him in public.

The sad episode finally came to an end in 1996, when an NIH appeals panel dismissed all charges and castigated its



own investigative office. Baltimore became a sort of hero, praised for his steadfast defense of his less powerful colleagues. Imanishi-Kari was belatedly awarded tenure at Tufts. Baltimore, who returned to MIT after resigning from Rockefeller University, was named president of the California Institute of Technology in 1996. (Kevles began work on the book and published his view of the case in *New Yorker* before Baltimore came to Caltech.)

Kevles' story is sometimes overwhelmed by detail, but it eloquently drives home the point that "a great injustice was perpetrated in the name of scientific integrity," as he puts it. Baltimore's reputation is now largely restored, but the lingering question of whether his defiance, his unwillingness to compromise, might have prolonged the sad affair. Those qualities served him well in science—but perhaps so well in the Baltimore case.

PAUL RAEBURN

Raeburn, *BUSINESS WEEK's* senior editor for science and technology, covered the Baltimore case for the *Associated Press*.

KEVLES SHOWS, IN UNRELENTING DETAIL, HOW THE BALTIMORE CASE SPUN OUT OF CONTROL

STEPHEN H. WILDSTROM

CATCHING E-MAIL IN THE FLY

Now PocketMail devices allow you to pick up messages in any telephone

depend on E-mail to run my life. As a result, I'm constantly on the prowl for new technology to keep in touch when I'm away from the office. I never would have suspected my search would lead me to a throwback to the dawn of the portable computer era, a so-called PocketMail. With it, I can fetch mail from anywhere.

Like a road warrior, I remember the acoustic coupler that connected early computers to the telephone system. The couplers were bulky and cranky devices that bleeped motions into a telephone handset. They worked where, even when I pay phones, office digital systems that were compatible with laptop modems. Updated acoustic couplers from startup TelScience is built into about 6 inches long, 3 1/2 inches wide, and 1/2 inch thick. The PocketMail product, the Portable E-Mail Device, costs \$100, plus \$9.95 a month (for mail service). It will be available in the second half of the year; the \$129 Sharp Electronics TelMail, which adds an address book and calendar to E-mail, ships in November. Switching either model to external E-mail is simple. You connect the PocketMail server's

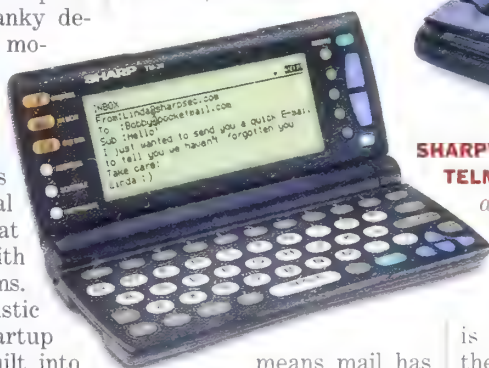
toll-free number, press a button, and place the phone against a receptacle underneath the base of the PocketMail device. With a series of beeps and bleeps, the unit sends messages and retrieves mail waiting on the server. The coupler adjusts to handle a variety of handsets. In my tests, only my Motorola MicroTac didn't work.

In this, its first incarnation, PocketMail (www.pocketmail.com) has a lot of drawbacks. The Sharp and JVC displays are readable but small. Building an address list and entering messages using the tiny keyboard is tedious.

A bigger drawback is that you can communicate only with PocketMail's servers, which

slow, equivalent to about a 2,400-bit-per-second modem in my tests. Memory is a scanty 128 kilobytes, so individual messages are limited to 4 Kb, and you can't read any attachments to the E-mail you get. I also found the controls on both the JVC and Sharp versions awkward.

Nonetheless, this is a promising technology. I would like to see PocketMail capabilities added to other devices. I think 3Com's PalmPilot with PocketScience technology would be easier to use than the dedicated PocketMail devices that I tried. Including PocketMail in handheld computers based on Windows CE would increase the usefulness of the devices and give PocketMail better E-mail software. Even a standard laptop with PocketMail is an intriguing possibility.



SHARP'S

TELMAIL: It adds an address book and calendar to E-mail, and will ship in November

Another appealing idea is for corporations to run their own PocketMail servers. This would allow mobile workers direct access to their corporate mail accounts without the hassles of forwarding.

Getting mail on the go is increasingly a business necessity. Even in its present, flawed incarnation, PocketMail is a useful tool for someone who needs to read mail—especially short messages—anytime, anywhere. And the technology has the potential to get a lot better.

BULLETIN BOARD

THE INTERNET

BROWSE SMARTER

Communicator 4.5, set for release on Oct. 19, is a welcome update of Netscape Communications' Web browser and E-mail.

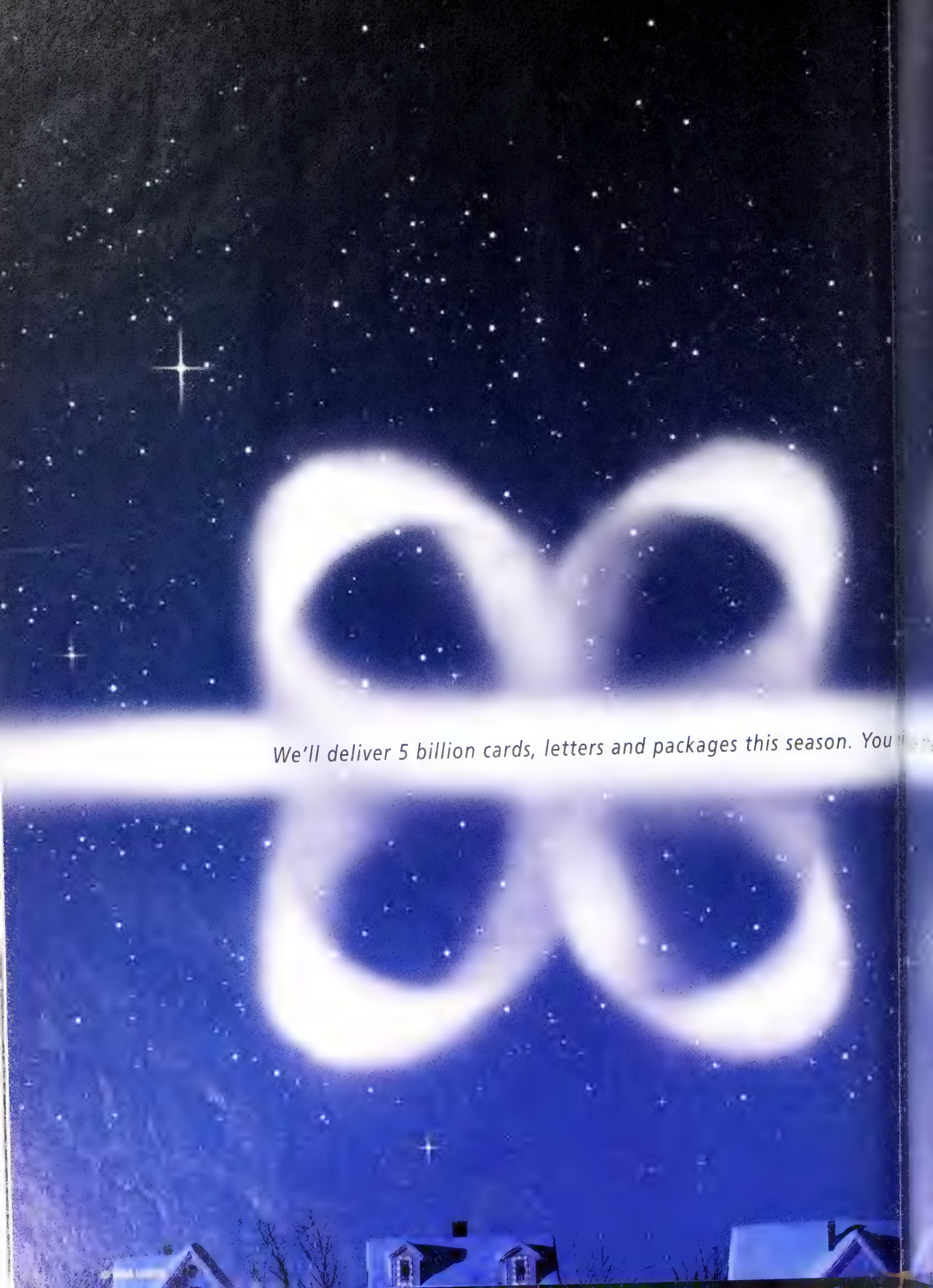
The main change in the browser is a feature Netscape calls "smart browsing."

When you type in a Web address, it makes an intelligent stab at what you are trying to do, even if you don't get it quite right. So if you type in "micorsoft," it will figure out that you probably want www.microsoft.com. It doesn't succeed all the time, but it can help. And once you open a Web page, a new "What's related" button offers links to similar sites. The biggest changes are in Messenger mail. A return to a three-pane display, abandoned in the shift from version 3.0 to 4.0, lets you see message headers, the

current message, and a list of folders on the same screen. You can move messages by dragging

them to a folder or to the trash. The size and placement of the three panes are easily adjustable, and you can have version 4's two-pane display if you prefer. Addressing messages is also much improved: The program automatically searches both your personal address book and an online directory, such as a corporate directory server, for addresses. If it finds more than one matching what you have typed, you can click the correct choice from a list. Communicator 4.5 will be available for free download from home.netscape.com.



A night sky filled with stars of various sizes. In the center, there is a large, glowing, stylized number 8 that appears to be made of light or smoke. The number 8 is composed of two loops, one above and one below a horizontal band where the text is located. The overall color palette is dark blue and black, with the stars and the glowing number providing the primary light sources.

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BY LAURA D'ANDREA TYSON

THE GLOBAL MELTDOWN: WHAT TO DO NEXT



PRIORITIES:
Major reform
will take time.
Meanwhile,
cut rates in
the U.S. and
Europe, buoy
Japan's banks,
ease IMF
austerity,
and extend
new loans

What caused the Asian financial crisis? Right after it ignited in Thailand in July, 1997, the Asian economies were seen as the culprit, particularly by Western investors who suffered huge losses in Thailand, Korea, and Indonesia. In a remarkable about-face, many of the world's most sophisticated financial institutions and market pundits who had hailed the Asian economic miracle began complaining about Asian crony capitalism. Never mind that per-capita income soared seven times in Hong Kong and South Korea and 4½ times in Malaysia, Thailand, and Indonesia during the previous 30 years—an unprecedented accomplishment in economic history. Never mind that these countries had followed textbook models of economic development, with balanced budgets, conservative monetary policy, high savings, and market liberalization.

Today, the “blame Asia” explanation has a decidedly hollow ring following Russia's dramatic default, the virtual disappearance of risk capital in emerging-market economies, and the near collapse of the hedge fund Long-Term Capital Management. Now that a global liquidity crisis threatens to throw the world economy into recession, attention is shifting from the structural weaknesses of emerging-market economies to the structural weaknesses of the international financial system. And criticism has shifted from the follies of borrowers to the follies of lenders.

PANIC ATTACKS. President Clinton has described the swift and unanticipated flight of private capital out of the emerging-market economies as analogous to bank runs on entire economies. This is an apt analogy in light of the fact that many of the economies that have suffered the greatest traumas are smaller than the global financial institutions that lent them billions in short-term money. With the benefit of hindsight, it is painfully obvious that there was nothing in the current international financial system to prevent either the excessive buildup of short-term borrowing when capital was pouring in or the credit crunch that strangled emerging-market economies when capital hemorrhaged out.

So what can be done to contain the recessionary forces that have now been unleashed and prevent future bank runs on whole countries? Given the precariousness of current conditions, the world community should heed the advice of James D. Wolfensohn, the head

of the World Bank, to focus on efforts to ameliorate the immediate crisis. Although reforms of the international financial system are necessary, they will take considerable time to design and implement. The contentious discussions of preliminary proposals at the recent annual meetings of the World Bank and International Monetary Fund indicate that the reform process will be painfully slow.

PROMISING STEPS. Immediate action is warranted on several fronts: cuts on interest rates by the U.S. and Europe, an infusion of new reserves into Japan's troubled commercial banking sector, a further easing of IMF austerity conditions in emerging-market economies, and the extension of new loans. Recent decisions by both the Federal Reserve and the Bank of England to reduce short-term interest rates and Japan's offer to extend \$30 billion in additional loans to the Asian economies are promising first steps. A credible adjustment package for Brazil would help rebuild investor confidence.

Two kinds of reform should receive top priority in remaking the international financial system. First, emerging-market economies must develop transparent, supervised financial institutions, monitored by either the IMF or the Bank for International Settlements. Developed countries should mount a program of technical and financial assistance to help with this essential task.

Second, as the U.S. has proposed, the international system must fashion some kind of contingency-loan facility that can be quickly mobilized by countries pursuing sound policies to resist sudden speculative runs. Admittedly, the wisdom of such a proposal hinges on prior agreement about what constitutes “sound policies” and “turbulent” market conditions. Reaching agreement on these controversial issues should be the first order of business. Had such a contingency-loan facility been available during the summer of 1997, the crisis that began in Thailand could have been contained instead of spreading and threatening the entire world economy. It is equally sobering to note that Japan's proposal for a new \$100 billion fund to combat currency contagion in Asia last year, which Washington defeated, could have had the same effect. But there is no time to lament the might-have-beens of the past. The tasks for the future demand our attention.

Laura D'Andrea Tyson is dean of the Haas School of Business at the University of California at Berkeley and was President Clinton's chief economic adviser.

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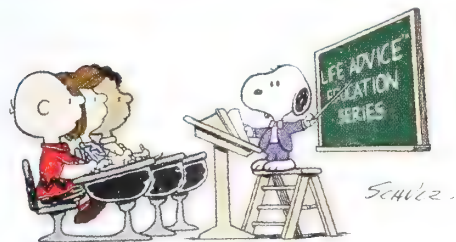


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Indiana, USA

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TOYOTA People Drive Us

BY GENE KORETZ

IT'S NOT JUST SOCIAL SECURITY

Seniors' medical bills keep soaring

It is a paradox whose implications perhaps only an economist can fully appreciate: Older Americans are leading ever longer and healthier lives, and costs of many treatments for illness are falling. Yet health-care outlays for the elderly continue to rise far faster than economic growth—at a pace that promises over the next few decades to eat into the living standards of many seniors and to sharpen tensions between

longevity that explains his projections, but the rise in oldsters' medical bills, up at nearly a 4% real annual pace over the past decade. At that rate, he estimates that health-care spending per senior will soar from \$9,200 in 1995 to almost \$25,000 (in 1995 dollars) in 2020—a hike that would strain the resources of both the government and seniors themselves, who on average shoulder over a third of their own health bills.

Seniors are spending more on health care because of the spectacular success of new medical technology and drugs, which often enhance the quality of people's lives even if they have little effect on mortality. As prices of new treatments come down, they become more widely used, adding to total spending. Meanwhile, pricey technological advances move through the pipeline. "It's an unrelenting process," says Fuchs.

It's also ultimately unsustainable. Other countries, notes Fuchs, slow the pace of technological change and diffusion by setting limits on funding and on eligibility for procedures. Such methods, he believes, are probably unsuited for America's individualistic society.

A more likely tack, he says, is to raise incentives for people to save and keep working in later years so that they can pay more of their medical bills. Another idea might be a tax-financed program to provide all Americans with vouchers to buy basic coverage that they could add to if they wanted to avail themselves of new, costly treatments.

"One way or another," says economist Fuchs, "America will have to tame the health-care gorilla."

A GOOD SPELL IN THE CLINK

New laws may deter some crimes

Do "three-strikes" laws and other measures that boost the sentences meted out to repeat criminals tend to reduce crime mainly by keeping people locked up, or does the threat of harsher punishment actually induce many would-be perpetrators to abstain from committing crimes?

In a recent National Bureau of Economic Research study, economists Daniel Kessler and Steven D. Levitt seek to answer this question by comparing the rates of crimes affected by California's Proposition 8 with those of similar crimes not affected by the law.

Proposition 8, which was passed and went into effect in 1982, raised sentences

by up to five years for criminals with previous felony offenses such as homicide, rape, robbery, assault with a gun, and burglary of a residence. But it did not cover such similar crimes as larceny, auto theft, burglary of a nonresidence, and assault without a firearm.

In the two years before the law passed, report the researchers, all of the crimes it covered were increasing in number—as were most of the similar crimes that it didn't cover. In the years just after the law passed, however, all covered crimes plunged dramatically, down 14% on average, vs. a 3% drop for the uncovered ones. Moreover, by 1985, covered crimes were down by about 20%, compared with an average 4.6% increase in similar uncovered crimes.

Since people sentenced to longer terms under the new law would have gone to prison anyhow, with no immediate impact on crime rates, the two economists conclude that Proposition 8 has had a strong deterrent effect on covered criminal activity. And that, they say, suggests that in many cases "three-strikes" laws and other sentence "enhancements" may be more cost-effective than many people believe.

SHIFTING TRAVEL COSTS FOR EXECS

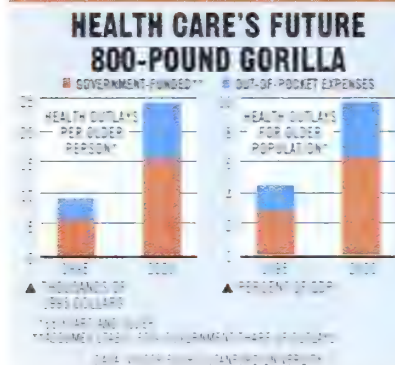
Some cities are a lot cheaper now

For U.S. executives traveling abroad figuring the tab for expenses is getting a lot harder. Due to currency shifts per diem rates have often been changing dramatically. In its latest survey of food and lodging rates in 100 cities Runzheimer International found that Tokyo has dropped from No. 2 in cost last year, to 16th. Other cities that have fallen from the top 10 this year (where per diem tabs range from \$818 to \$472) include Prague and Taipei.

The cheapest city in the survey is Hamilton, Ontario, with per diem costs of \$97. Among other bargains are Bangkok and Jakarta, whose tabs are down from \$261 and \$258 a day last year, to \$137 and \$118.

WHERE THE STAYING IS PRICEY

RANK	CITY	PER DIEM COST (IN U.S. DOLLARS)
1	MOSCOW	\$472
2	CHENGDU	\$472
3	BEIJING	\$472
4	NEW DELHI	\$472
5	NEW YORK	\$472
6	PARIS	\$472
7	HAMAM	\$472
8	SINGAPORE	\$472
9	BEIJING	\$472
10	BEIJING	\$472
11	BEIJING	\$472
12	BEIJING	\$472
13	BEIJING	\$472
14	BEIJING	\$472
15	BEIJING	\$472
16	TOKYO	\$472
17	TOKYO	\$472
18	TOKYO	\$472
19	TOKYO	\$472
20	TOKYO	\$472



retirees and younger workers, whose taxes help cover their medical bills.

"Although people justifiably worry about Social Security," says Victor R. Fuchs of Stanford University, "paying for old folks' health care is the real 800-pound gorilla facing the economy."

In a new study, Fuchs assesses the problems that lie ahead. Based on recent health-spending growth trends and Census Bureau projections—that the 65-and-older crowd will expand from 13% of the population today to 16.5% by 2020—he estimates that the share of gross domestic product devoted to health care for the elderly could double by 2020, to around 10%.

Even if other medical spending stays at around 10% of GDP, that implies that the nation's total health-care bill would rise from 14% of GDP in 1996 to about 20% by 2020. By contrast, in almost all major industrial nations except the U.S., total health spending for everybody still amounts to no more than 10% of GDP—and usually less. And in many of these nations, the elderly already represent 16% of the population.

Indeed, Fuchs notes that it's not mainly the growth in senior ranks or in

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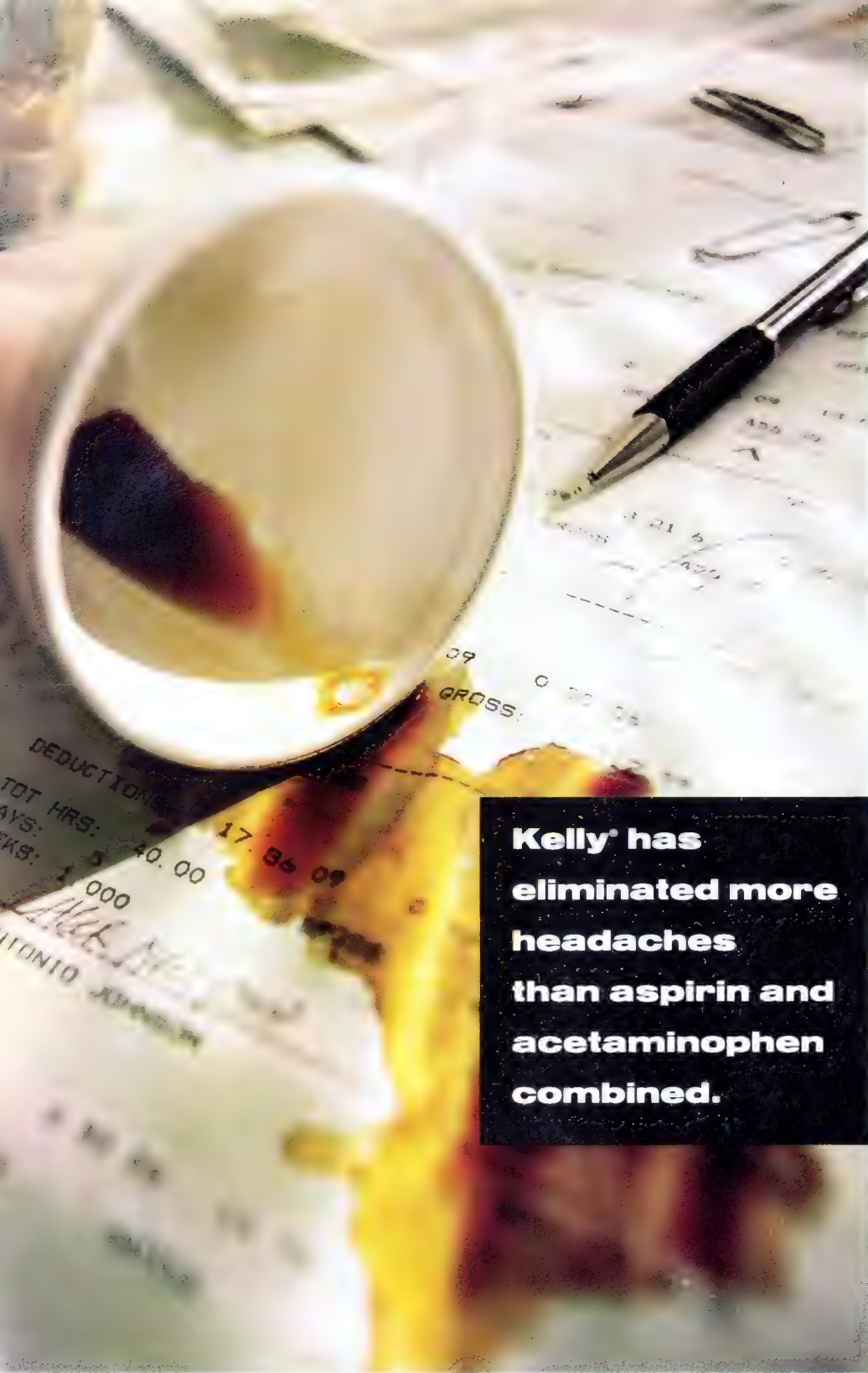
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/ JAMES C. COOPER & KATHLEEN MADIGAN

THE CREDIT SQUEEZE S STARTING TO PINCH

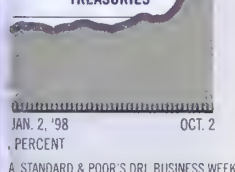
Heavier borrowing costs are another weight on the economy's shoulders

U.S. ECONOMY

In one crucial way, the coming economic slowdown is similar to those of the past: Credit is getting tighter. The big difference is that the Federal Reserve did not trigger a tightening. This time, with a nudge from chillier financial conditions abroad, the financial markets themselves did the dirty deed. Nevertheless, the impact on the U.S. economy will be the same. Domestic demand in credit-sensitive sectors—capital spending, consumer outlays for big-ticket items, and housing—will take the biggest hit. Also, the \$1.5 trillion loss in net wealth since mid-July will be felt to some extent in overall consumer spending and saving. Even Federal Reserve Chairman Alan Greenspan recognized that the sharp runup in stock prices “has been a major factor galvanizing consumer expenditures and holding up housing sales.” Now, though, some of that support is gone.

CREDIT SPREADS WIDEN SHARPLY

YIELD SPREAD BETWEEN
BAA-RATED CORPORATE
BONDS AND 30-YEAR
TREASURIES



The current credit squeeze and loss of wealth are two reasons some economists are raising the probability of a recession in their 1999 forecasts. Use of the “R” word still seems premature, but clearly, all eyes will be watching the data for signs of just how much the economy is slowing. What should grab the biggest attention? The indicators on domestic demand. Such diverse data as capital-goods orders, jobless claims, consumer confidence, and mortgage applications will be the numbers to watch.

DO YOU HAVE FINANCIAL CONDITIONS changed so abruptly? After years of soaring stock prices and free-flowing credit, investors suddenly decided that the world was a much riskier place than they had thought (partly). Greenspan himself has acknowledged that the financial-market imbalances arose in large part because investors had begun to underestimate greatly the risk associated with stocks and bonds. As far back as December, 1996, when Greenspan questioned the stock market’s “irrational exuberance,” concern was based on the fact that various measures of risk tolerance, including yield spreads and equity premiums, had fallen to negligible levels. A combination of Asia’s crisis, sagging U.S. profits, the

Russian debt default, and U.S. political uncertainty is what woke investors up.

What is happening now, Greenspan says, “is a major shift toward risk aversion pretty much throughout the world.” At the same time, commercial banks are starting to tighten up what had been fairly lax lending standards, especially for businesses. The result: The cost of capital is rising on two fronts. Borrowing in the credit markets is more expensive, and amid sagging stock prices, equity capital is dearer as well.

The credit squeeze shows up in the yield spreads between corporate debt issues and riskless Treasury bonds. For example, the spread between moderately risky BAA-rated corporates and 30-year Treasuries has soared in recent weeks to levels not seen since the 1990-91 recession. The spread even for top-quality AAA-rated corporates has widened. The AAA yield has declined, but Treasuries have fallen much more.

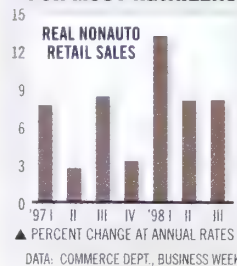
THE HIGHER COST OF CAPITAL makes capital spending, a key force in this business cycle, the most vulnerable sector in the economy right now. That’s especially true since weak profits continue to limit the ability of companies to finance their equipment and construction projects internally.

How companies place new orders will contain the most information on how much damage this unwinding of financial-market excesses is doing. Through August, capital-goods orders have been holding up. But the critical months are those upcoming, as businesses digest the latest round of financial-market tightening.

The other crucial sector is, of course, household spending. As they almost always do, consumers will determine the degree of the economy’s slowdown. They have lost some confidence, but as strong September car buying and a rise in retail sales show, they are still shopping (chart). September retail buying rose 0.3%, and third-quarter real consumer spending appears to have grown at a solid 3% pace.

Amid excellent income growth and big wealth gains from the past surge in stock prices and mortgage refinancings, households have been able to handle fairly high debt burdens and an extremely low savings

ANOTHER GOOD QUARTER FOR MOST RETAILERS



rate. Also, while debt service costs for installment debt as a percentage of income have climbed far above the late-1980s level, overall debt service is below the 1980s peak, because the carrying cost of mortgage debt has declined sharply in the 1990s.

However, lost wealth already appears to be affecting upper-income consumers. September chain store results showed considerable sales weakness among upscale retailers. Discounters, meanwhile, posted strong gains, reflecting the lower importance of stock market gyrations to most middle-income households, as well as the strongest growth in production workers' real wages since the 1970s. Pay is up 4%, with inflation running less than 2%.

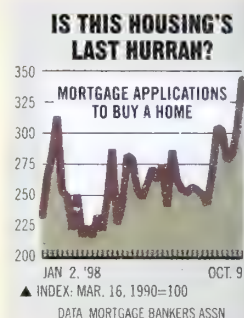
Because paychecks are much more crucial to this segment of households, the labor markets will remain central to the consumer outlook. The key indicator to watch is weekly initial claims for unemployment insurance. Despite the September slowing in payroll gains, new claims throughout September remained at the lowest level since 1989. Claims are sensitive to economic turns, and they will provide an early warning if job growth is slowing sharply.

THE FINAL SECTOR that is always vulnerable to a tightening of financial conditions is housing. Supportive financial conditions, including stock market gains and cheap mortgage financing, have upheld gains in

homebuilding and sales that have been far and above what demographics projected to be possible. The prime home-buying age group has shrunk sharply in recent years, but homebuilding in the first half rose at the fastest pace in four years.

With mortgage rates still very low, reflecting the drop in Treasury yields, housing should hold up fairly well in coming months. But the summer of 1998 was probably housing's last hurrah. Two key indicators will point the way in coming months: weekly mortgage applications and the monthly survey of homebuilders' assessments of market conditions. In the most recent week, ending Oct. 9, applications to buy a home shot up 12.9%, to a record high (chart). In addition, weekly applications to refinance soared 28.7% also to a record high.

The ongoing tightening of credit conditions, at least the way in which this one has come about, is highly unusual in economic history. Greenspan said flatly: "I have never seen anything like this." What we can bet on is that the U.S. economy will slow. By how much? For that one keep one eye on the financial markets, and the other on the data.



BRITAIN

A CUT, A PALPABLE CUT

In an effort to stave off recession, the Bank of England joined the ranks of interest-rate cutters. On Oct. 8, it dropped its benchmark rate by a quarter point, to 7.25%, days after similar cuts by the Federal Reserve and the Bank of Spain and just hours after Denmark trimmed rates. The BOE move, the first in two years, was followed by rate cuts in Portugal and Ireland.

In its policy statement, the BOE said deteriorating global conditions meant that the outlook for demand and output has "weakened." Already, British purchasing managers say that manufacturing, especially the high-tech sector, has been shrinking for six months, a

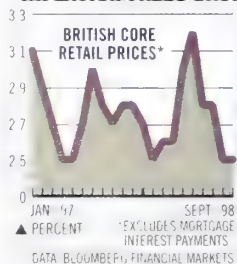
victim of falling export demand. Industrial production fell 0.4% in August, while past hikes in mortgage rates have slowed homebuilding. The Treasury has cut its real gross domestic product forecast for 1999 to show growth of 1%, a sharp revision from the 1.75% to 2.25% projected last March. Real GDP is still expected to grow 2% to 2.5% this year.

Consumer demand is beginning to slow, although special factors are distorting recent data. First, cold weather this summer boosted demand for food and clothing compared with a year ago. Second, the September figures are skewed because shops closed for part of last September

following the Princess of Wales' death. Consumer confidence, however, is starting to crack as concerns about global uncertainties outweigh the security of growing incomes and tight job markets.

The BOE had leeway to cut because inflation has become less of a threat. Core retail prices, which exclude mortgage interest payments, were increasing as much as 3.2% in the year ended in May, but they were up just 2.5% in September (chart), equaling the bank's target rate. Producer prices paid at the factory gate fell 0.1% in September and rose 0.3% from a year ago, the lowest annual rate in 38 years. Extremely low inflation, along with the downshift in growth prospects, should give the BOE ample room to cut rates further, perhaps again in this quarter.

AFTER A SPRING JUMP, INFLATION FALLS BACK



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 **network**
ASSOCIATES
Who's watching your network

Economic anxiety level of Planet Earth from the far reaches of a slight easing in recent days. They may have observed that the fall of the U.S. dollar has worked a bit like an economic shock absorber, cushioning as emerging markets cratered and investors poured into the safety of the greenback and U.S. Treasuries.

But will the relief be lasting? The currency realignment, though driven largely by technical factors, does reflect something new about the relative economic strength of the U.S., Japan, and the European Union and the consequent expectations for lower global interest rates. Certainly, the remarkable U.S. recovery since the recession's endward is showing signs of fatigue, and the Fed is flirting with more cuts on top of the quarter-point reduction of Sept. 29. At the same time, the steady Continental economies, especially Germany, look like relatively safe havens. Europe, excluding Britain, is running a \$100 billion current-account surplus, justifying strengthening of the mark, French franc, and Dutch guilder.

And maybe, just maybe, the yen will be able to hold on to some of the ground it has retaken—rising from as low as 147 to the dollar on Aug. 8 to as high as 111 on Oct. 8. Tokyo has finally floated a credible plan to fix its crippled banking sector. It also is lining up \$84 billion in new public-works spending and tax cuts to ease the sting of its worst postwar recession. "For the first time, there are signs of hope" coming out of Japan, suggests Lawrence A. Bossidy, chairman and chief executive of AlliedSignal Inc.

CHINA FACTOR. Not that anything is settled. The currencies are still adjusting, seeking a new equilibrium. Many economists are looking for a yen-dollar rate of between 125 and 130. That would still be enough, they say, to take the pressure off other Asian currencies and avoid competitive devaluations, especially by China.

"What people are worried about is 145, a level that is considered unsustainable, especially if the global econ-

omic recovery is slow," says

chief economist at Standard & Poor's. "If it goes back to that level, we'll likely see China go, which would trigger a second round of devaluations through Asia." But if the yen holds at around 130, "no one will be unhappy," he concludes.

Certainly not the Treasury or the Federal Reserve, where officials call

LETTING OFF STEAM

The recent
currency
realignment
has provided
relief. But
can it last?



the greenback a major "transmission channel" for its attempts to ease and bolster a slowing economy. A cheaper dollar means cheaper exports, which could help restore growth in manufacturing (page 36).

In fact, Japan would be ecstatic if the dollar were to stabilize at a slightly weaker level than its current 119. As the yen strengthens, Japanese corporations lose profits. Toyota Motor Corp., for instance, had based its financial planning and earnings forecasts on an average yen-dollar rate of 125. At 119, Toyota has seen its theoretical profits decline from its forecast by 60 billion yen, or \$504 million.

But the stronger yen is good news for the rest of Asia. Indeed, on Oct. 12, Pacific Rim markets rallied on bets that a stronger yen would boost Asian exports by taking the heat off other regional currencies, particularly the Chinese yuan and Hong Kong dollar. Hong Kong Financial Secretary Donald Tsang even said that if the yen-dollar relationship doesn't revert to earlier levels, "we are now running toward the end of [Asia's] economic crisis."

If the yen could still fall back to where it was—or lower. One of the big reasons for the dollar's precipitous dive was a sudden need by hedge funds to get out of their leveraged short positions on the yen—forcing them to sell dollars and buy yen. But that phenomenon, says Michael Rosenberg, head of international fixed-income research at Merrill Lynch & Co., was a "one-off shock to the system." His prediction: "The dollar should come roaring back"—plunging the yen to around 160 by March 1999.

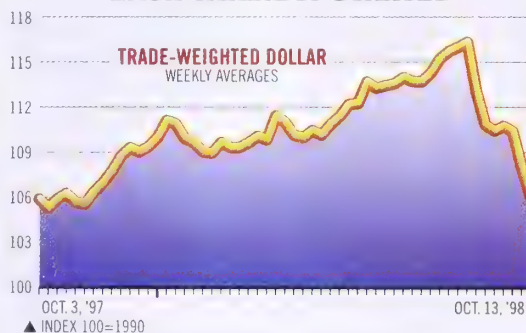
Yen bears have a compelling case. Despite the new, improved bank-rescue plan that would include \$510 billion worth of government money, the outlook for the Japanese economy, corporate earnings, and the Nikkei is pretty dreadful. After contracting 0.7% last year, the economy is likely to tumble 2% this year, and government officials concede it could tank again in 1999.

Even now, it's far from clear Tokyo can avoid bank failures and perhaps a full-blown financial panic. Restoring banks to full health will take years—not months. Nor are the new spending and tax cuts likely to have impact until well into next year. Salomon Smith Barney figures they would add maybe 0.6 per-

centage point to 1999 gross domestic product but not enough to avoid recession. "I don't think there is one magic wand to cover all of our problems," concedes Ichizo Ohara, a top economic adviser to Prime Minister Keizo Obuchi.

The outlook for key European currencies—and the new euro—is even less clear. J.P. Morgan's chief global currency strategist, Avinash Persaud, thinks the dollar will be dragged lower vs. the European currencies as foreign money exits U.S. equity markets. The dollar, he adds, will also come under pressure from the U.S. trade deficit, likely to hit \$234 billion this year. Officially, the new European Central Bank says the current level of the dollar "is not a cause for concern." But come January, when the ECB takes charge, the betting is that it will push down a newly converged interest rate for the 11

THE DOLLAR: A YEAR LATER BACK WHERE IT STARTED



DATA: MORGAN GUARANTY TRUST CO.

economies it oversees to just below the German benchmark rate of 3.3%. That would nudge the euro down against the dollar, and help European exporters.

Of course, the Fed has a lot more room than either the ECB—which is defending a new currency—or the Bank of Japan, which has already cut rates to 0.25%. If the Fed cuts again to avert a recession, the dollar will look a lot less attractive.

CLEAR DANGER. But such cuts might only be justified if a U.S. recession becomes a clear and present danger. And that would spell trouble for the global economy: If the U.S. slips into recession, global growth would dip below 2%—for the first time since 1982. In that scenario, there is little hope for recovery for Japan and the rest of East Asia. As it is, only two countries in

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Asia, China and Taiwan, will generate positive growth this year. Imagine what would happen next year if the U.S. could absorb only a trickle of East Asian imports? Even without a recession, a less robust dollar makes imports more costly. "Whatever joy these economies get from weaker currencies against the yen would be lost from a big contraction in global demand," says Lehman

Brothers Inc. economist Russell Jones. So maybe the best that can be hoped for now is a stretch of currency stability between the dollar, yen, and euro. That would give the efforts by the Group of Seven and the International Monetary Fund a chance to take root. And emerging nations would be far less tempted to manipulate trade flows and debt repayments by messing with their currencies.

"To have plus or minus 10% change makes it difficult for all concerned," says Douglas A. Warner III, J.P. Morgan chairman and CEO. Or to put it another way: The last thing a frail global economy needs is another psychotic episode in the currency markets.

By Brian Bremner in Tokyo, with Kerry Capell in New York and Mike McNamee in Washington

COMMENTARY

By James C. Cooper

A NOT-SO-BRAWNY GREENBACK TO THE RESCUE!

You have to wonder if Federal Reserve Board Chairman Alan Greenspan and Treasury Secretary Robert E. Rubin are silently applauding the dollar's recent weakness. Since late August, the trade-weighted U.S. currency has dropped 10%. But a less muscular greenback could be the first step toward world financial market stability.

Clearly, no policymaker wants a repeat of the dollar's chaotic Oct. 8 plunge vs. the Japanese yen: As hedge funds had to sell dollars to cover bad bets on a falling yen, the dollar sank 9% in that session. And a stronger yen hurts Japan's export prospects, even as the country is gripped by recession.

EXPORT BOOST. However, an orderly decline in the dollar will accomplish several things crucial to getting the global economy back on its feet. First, a weaker dollar will help the U.S. economy by lifting pricing power and boosting exports in the hard-hit manufacturing sector. Also, it will relieve pressure on economies with dollar-pegged exchange rates, such as Brazil and Hong Kong. Plus, it will lift the export competitiveness of emerging Asian nations, particularly South Korea, by providing a currency advantage over Japan. Finally, it will help to redirect capital to non-dollar investments, a crucial step in restarting battered economies.

A weaker dollar is justified by fundamentals. With the Fed cutting interest rates, and with prospects for U.S. growth diminishing, dollar-based investments are becoming rel-

atively less attractive. Also, the U.S. current-account deficit, comprising the gaps in foreign trade and net investment income, hit 2.7% of gross domestic product in the second quarter, a full percentage point rise in

The 10% drop, by itself, is equivalent to a $\frac{1}{2}$ - to $\frac{3}{4}$ -point cut in rates by the Fed. And the stimulus will provide recession insurance by going mainly to the U.S. manufacturing sector, where the Asian crisis has left its deepest scars, including weak pricing and profits, stagnant output, and layoffs.

Internationally, a weaker greenback will improve the prospects of ailing foreign economies by lessening the likelihood of speculative attacks on their currencies. Policymakers have made Brazil their first line of defense against further global turmoil, and a weaker dollar would take pressure off the Brazilian real. China would also be less likely to devalue.

A key risk to this scenario would be Japan's failure to carry through with its latest recovery initiatives, especially the bank bailout. Currency markets would turn on the yen, pushing the dollar back up. Another risk is

U.S. inflation. After all, the dollar's 25% surge since 1995—and the resulting drop in import prices—has been a key factor curbing overall inflation in a very strong economy.

But on balance, a modest devaluation of the dollar is a welcome development. Remember, the Asian crisis was first and foremost a currency crisis. It was the superstrong U.S. dollar that helped to expose Asia's underlying economic problems, leading to the collapse of its currencies. Some moderation in the dollar must be a key part of the solution.



TOKYO TRADERS: Hedge funds spurred dollar sales

the past year. It is now probably greater than 3% and approaching levels that preceded the dollar's decline in 1985. The markets rarely allow any free-floating currency to remain strong when it faces foreign obligations that large.

Moreover, Japan may be moving to fix its banking system—Japan's and the world's No. 1 financial problem. If so, Japan could begin its return to health, boosting the allure of yen investments. Also, a stronger yen increases the import purchasing power of Japanese consumers.

For the U.S., a weaker dollar acts like an easing of monetary policy.

Cooper writes the Business Outlook.

HUNKERING DOWN IN A HURRY

earing a slowdown, execs
e slashing costs

During the long bull market, the annual gatherings of the 100 top chief executives who are active members of the Business Council were invariably joyous affairs. But at the conclave that ended Oct. 10 in Colonial Williamsburg, mood was as dreary as the drizzle. It forced most CEOs to cancel their golf games. "We're coming down the other side of the mountain," reported the Council's vice-chairman, J.P. Morgan CEO Douglas A. Warner III. "We all agree [the economy] is going to slow down," he

pled, brandishing a key that found 60% of the Council's members believe the global crisis will depress growth with "throughout the next year or all of next year." The rest fear impact will extend "several years."

But now that business leaders have shed their rose-colored glasses and focused on the looming slowdown, there may be reason to hope they can minimize the damage. Even Warner, whose firm is one of the few predicting an actual recession in 1999, says he is "struck by the speed" at which CEOs are responding to the changing environment. In marked contrast to past slowdowns, when CEOs often tried to postpone their pain, virtually every day brings fresh announcements of companies planning major layoffs and restructurings in the aftermath of a third quarter that promises the first drop in corporate earnings in seven years.

And it's just the first wave. As companies draw up their 1999 budgets, a surprising number are taking such measures as cutting capital spending, reduc-

ing hiring plans, or trimming other spending, ranging from advertising to entertainment. U.S. companies "will bathe down the hatches," predicts AlliedSignal Chairman Lawrence A. Bossidy, adding, "I don't see any reason to postpone things."

"EXCEEDINGLY TOUGH." But the preemptive moves carry their own risks. If companies cut too aggressively, they could make the downturn worse—by convincing workers that their jobs could be the

next to go. That might curb consumer spending and push the U.S. into recession. "We are entering dangerous territory," worries David Wyss, chief economist at Standard & Poor's DRI.

Even without a recession, business conditions "are going to be exceedingly tough in 1999," warns Maureen Allyn, chief economist at Scudder,

Kemper Investments Inc. With the U.S. economy slowing and much of the world mired in recession, revenue growth will be anemic, under 3%, she says. Meanwhile, profit margins are shrinking as the tight U.S. labor market forces companies to pay workers more. "We are seeing all the signs of a profits squeeze," adds Ned Riley, chief investment officer at BankBoston.

A key reason for the pessimism is that many U.S. companies are worried about their ability to price their way out of profit trouble. Just 4% of the blue-chip companies surveyed by the Business Council said they have "more pricing power" than a year ago, while 62% said

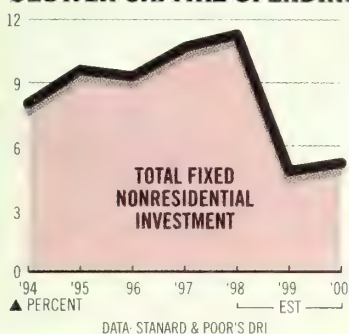
they have less. Sure, a weaker dollar would boost pricing power. But it hasn't yet. On Oct. 13, Eastman Kodak Co.'s stock plunged 13% after the photo giant reported its third-quarter U.S. consumer-imaging sales fell 10% to \$849 million. Kodak actually sold 2% more film in the U.S. But the brutal battle with Fuji Photo Film Co. forced Kodak to slash its U.S. prices by 10%. Now Kodak, which has already cut 10,000 jobs, is planning to slash another 10,000 positions.

Indeed, in this environment, CEOs eager to shore up profits have few options other than cutting costs. On Oct. 8, Raytheon announced it would lay off 14,000 employees, up from the 8,700 it had announced last January. And in health care, Thomas F. Frist Jr., CEO of Columbia/HCA Healthcare Corp., figures that 25% of the not-for-profit hospitals in the U.S. are nearly bankrupt, and another 30% are heading that way. As a result, "I see massive reductions across the country, not just us," he predicts.

The heads are rolling on Wall Street as well, where third-quarter earnings are coming in as much as 80% below year-ago levels. On Oct. 13, Merrill Lynch & Co. announced a 5% payroll cut, about 3,400 jobs. Tough market conditions "will delay the growth of our firm," says CEO David H. Komansky.

Most companies are also putting capital spending under the knife. According to the Business Council's survey, 64% of blue-chip companies have pared capital-spending plans in recent months. Merrill, for one, is planning to cut technology spending, including axing 900 consultants. And Intel Corp. says it

SIGN OF THE TIMES: SLOWER CAPITAL SPENDING



f companies cut too much, the economy may get worse. We're entering dangerous territory," says one forecaster

now expects capital spending to total just \$4.2 billion this year, down from the \$5.3 billion it expected in January—and down from the \$4.5 billion to \$4.7 billion it was forecasting just weeks ago.

COLD FEET. Countless smaller companies are making similar calculations. Across the economy, DRI expects capital spending to grow just 4.8% next year, down from 11.3% this year. “We’re pulling in our horns,” says Charles R. Patten Jr., president of \$29 million Colfax Envelope Corp. in Buffalo Grove, Ill. He is delaying a \$4 million expansion plan. “I’m concerned about the global situation,” he explains. “The way I see it, consumer confidence is going down.”

Executives everywhere are getting cold feet, it seems. Brunswick Corp. is closing 15 bowling centers in Asia, Brazil, and Europe; moving assembly of bikes from an Illinois plant to Mexico; and cutting a third of its distribution warehouses. Even brash media mogul Rupert Murdoch is exercising caution. In announcing that he would delay his planned initial public offering of Fox movie and television interests, Murdoch cited worries about advertising spending in a weaker economy.

For its part, UAL Corp. is making major changes in its route structure to cope with the spreading crisis. United is moving six of its enormous 747s from the Pacific to the U.S. domestic market by next spring because they couldn’t fill the planes on Asian routes. “We kept looking at Japan and saying things weren’t as bad as they looked,” says President James E. Goodwin. “In reality, they were much worse.” United is also closely monitoring its least profitable U.S. routes so it can pull out quickly if revenues slide.

To be sure, not everyone is cutting back. And demand for high-ticket discretionary items such as boats, motor homes, and motorcycles remains surprisingly strong. Consider Harley-Davidson Inc., which on Oct. 13 announced its third-quarter net income soared 27.4%. Harley predicts production will soar 10% to 163,000 next year. Indeed, there’s a wait of up to a year for Harley’s Road King Classic.

But increasingly, such companies are the exceptions. For too many others, the glory days of the past seven years are now passing into distant memory—crowded out by the reality of a more challenging and dangerous future.

By William C. Symonds in Boston, with Lorraine Woellert in Colonial Williamsburg, Richard M. Melcher in Chicago, and bureau reports

SUDDENLY, IT IS A SMALL WORLD —FOR PROFITS

It has been a busy month for Michael D. Eisner. Promoting his new book, *Work in Progress*, the Walt Disney Co. chairman has dashed from Katie Couric to Charlie Rose and on to other talk-show hosts. Then his pilot headed Mickey One to Atlanta for the opening of *Elaborate Lives*, the Disney musical based on the opera *Aida*.

Most recently, Eisner’s itinerary turned decidedly less festive. With Disney expected to announce annual earnings growth of 3% or less in early November, Eisner headed for a strategy meeting with two dozen top executives at his farm in Saxons River, Vermont. There they surveyed the damage that Disney has suffered from the Asian meltdown—and braced for slower U.S. growth. Despite such popular summer movie releases as *Mulan*, Disney’s film unit is facing lower earnings. And its ABC network is expected to earn less than \$200 million, down from \$490 million in 1996. Now, for the first time in years, Team Disney is being told to find ways to trim spending.

OPPORTUNITY? But Disney dares not cut too deeply. Like other media giants, it is racing to strengthen its brands in an increasingly fragmented media and entertainment market. “The world economy hit a speed bump,” Eisner said on the *The Charlie Rose Show* on Sept. 24. “That causes one of two things: no sleep, or opportunity. So I chose opportunity.” Disney contends that its troubles are mainly the result of Asia’s woes, which have hurt sales there.

But analysts say the problems go deeper. One example: Disney’s film division spent a hefty \$80 million-plus to make and market *Six Days, Seven Nights*, starring Harrison Ford and Anne Heche. So despite grossing \$74 million, the movie is unlikely to be profitable. *Mulan* was a hit, but

“*Mulan* will do less than half what *Lion King* did—good, but not the home run this company needs right now,” says John Tinker, a media analyst for NationsBanc Montgomery Securities. Analysts expect Disney’s creative unit, which includes the studio and consumer products, to earn roughly \$1.6 billion this year, down from \$1.9 billion in 1997.

Disney has already shaved about \$500 million in annual costs from its film studio by reducing the number of films it makes and seeking partners. Capital Cities/ABC pared an estimated \$30 million from its budget and has frozen hiring and bonuses. “I have the

greatest respect for Michael Eisner and his ability to find a way,” says Viacom Inc. Chairman Sumner M. Redstone. But “they definitely have some problems at ABC and in the foreign markets.”

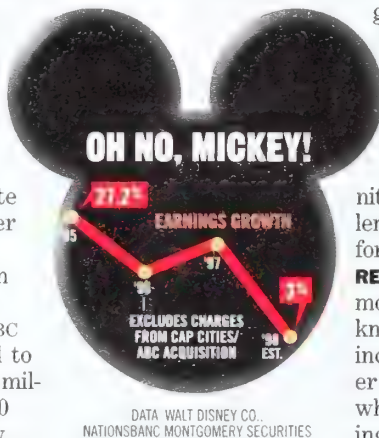
RESISTANCE. The Vermont powwow, says one knowledgeable source, included reviews of other plans—including whether to keep opening a new Disney Store

weekly for the next year. ABC is also talking to Time Warner’s CNN about sharing the costs of news gathering.

Some of Disney’s moves have met with resistance. Customers complained loudly when Disney tried to delay the opening of some Disneyland rides to midday. And Eisner himself raised a firestorm of protest by suggesting that ABC affiliates might have to pay for the added costs the network took on when it renewed its National Football League contract.

Still, Eisner is pushing ahead on other fronts. The company is aggressively expanding on the Net, and it’s spending an estimated \$1.4 billion to build a California Adventure theme park alongside Disneyland in Anaheim, Calif. But the Mouse Kingdom’s business plan for dicey times remains a work in progress.

By Ronald Grover in Los Angeles



GREAT BIG TRIAL IN A GREAT BIG HURRY

S. vs. Microsoft will sail by—and the company isn't happy

There's always a frenzy before lawyers go to trial. But with only days to go before Judge Thomas Field Jackson was scheduled to call opening statements in *U.S. vs. Microsoft*, lawyers at Microsoft Corp. headquarters in Redmond, Wash., and in the halls of the Justice Dept. were setting records for pretrial jamming. That's surprise to legal experts. "There is nothing normal about (this case)," says Stephen M. Klein, an antitrust lawyer at New York's Axxin, Vello & Harkrider.

No, indeed. Judge Jackson has been sure of that. The moment he got the case in May, he told both sides he had determined to streamline the proceedings. They would have five months to gather evidence and be allowed just 12 witnesses each. "Full-monopolization cases are usually protracted in years, months," notes Klein. If all goes according to Jackson's plan, this one would wrap up in a matter of eight weeks—less time than it

took to whip up a new web browser. And that's the point. The first major antitrust trial of the Internet Age will be held on Internet time. Why? So that when a decision is finally handed down, there may be hope that it will have some relevance in the quickly changing industry. That would be the reverse of the great information-technology case, *U.S. vs. IBM*. It was filed in 1969 and dismissed in 1982—by which time most of the issues were moot and IBM had gone

from the unquestioned leader to a giant under assault by smaller companies.

That just won't do these days, when Internet years are counted like dog years. With each passing week, millions of copies of Windows 98 will be sold, each with technology—Microsoft's Internet Explorer browser and its variation of Sun Microsystems Inc.'s Java—that, Justice claims, is being marketed in a way

at a cost—and Microsoft argues that cost is justice. The company says that the tight schedule leaves its lawyers little time to prepare a defense, especially since the government was still introducing new evidence just 11 days before the trial was scheduled to start. On Oct. 8, Justice added two new witnesses—an Apple Computer Inc. executive and a Sun executive—who will testify in place of an economist and a customer.

"POP QUIZ." Microsoft sought a two-week postponement, but on Oct. 13, Jackson denied the request—as he has denied its previous requests for more time. "Apparently the government thinks a federal antitrust case should be a pop quiz rather than a careful examination of the issues," gripes Mark Murray, a spokesperson for Microsoft.

Microsoft Internet Explorer

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HOW TO STREAMLINE A TRIAL FOR INTERNET TIME

- The trial is scheduled to begin just 5 months after Justice and 20 states filed suit.
- Each side is limited to 12 witnesses, compared to scores of witnesses in the IBM case.
- Direct witness testimony will be submitted in written form to the judge, with only opening statements, cross examinations, and redirect to take place in open court.

Internet zone

that squelches rivals. For example, as Microsoft has tied its Explorer browser more intimately to Windows, Netscape Communications Corp. has seen its browser share drop off. "There's a limited window of opportunity for these products to take off and succeed," says Carl B. Shapiro, a professor of economics at the University of California at Berkeley. "If that window closes, antitrust has failed to do its job."

But the expediency of the case comes

Even some Microsoft critics are sympathetic. Says Samuel Miller, a San Francisco lawyer who played a key role in Justice's 1994 probe of Microsoft: The defendant is "always scrambling to keep up with what the plaintiff is doing."

Government lawyers, however, suggest Microsoft is just stalling, and that it has had plenty of warning about what is coming, particularly in the case of Sun which has been fighting Microsoft in civil court. And in recent weeks Microsoft in

Microsoft argues that the trial's schedule leaves it little time to prepare a defense. Critics say it's stalling

fact has embarked on its own new fact-finding mission, subpoenaing new evidence from competitors as well as from the authors of a book about Netscape—an effort that ended when a Boston judge ruled that Microsoft would not be permitted to subpoena confidential notes.

The fast pace doesn't help the Feds, either. Most experts agree that the government's broad-based case will be hard to pull off. "There is a chance that their case will look superficial," says William E.

Kovacic, a professor of antitrust law at George Washington University.

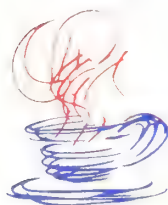
Indeed, Jackson must strike a delicate balance between justice and speed, since the verdict could have a far-reaching impact on the evolving Net software market. "The danger here is that by proceeding too rapidly, the trial could set a precedent for industry regulation that stifles innovation and ultimately damages the economy," says Roger McNamee, president of Integral Partners, a

Silicon Valley venture-capital firm.

Of course, that's exactly what Justice claims is the result of Microsoft's alleged monopoly. So, the government is betting big here. Under the legal principle of *res judicata*, Justice will basically be barred from ever attacking Microsoft on the same facts again. "This is their one bite at the apple," says Kovacic. So the case better have teeth.

By Amy Cortese and Mike France in New York, with Steve Hamm in San Mateo

SUN TAKES THE STAND



When the Justice Dept. sued Microsoft Corp. in May, Exhibit A was the software giant's behavior in the browser wars—specifically Microsoft's "tying" arrangements to

force computer makers to use its browser. That part of the case is shaky after an appeals court ruled that bundling the browser with Windows 95 was legal. So, as the trial gets under way—on Oct. 19, barring last-minute delays—Justice will focus on another alleged pattern of anticompetitive behavior: Microsoft's efforts to derail Sun Microsystems Inc.'s Java language.

Justice hasn't suddenly discovered Java, which was in the original suit. And the core of the case is still alleged anticompetitive acts involving rival browser maker Netscape Communications Corp. But the department's pretrial maneuvering shows that Sun will play a bigger role. In the final days before trial, Justice changed its witness lineup to include a new key witness: James Gosling, a Sun vice-president and the creator of Java. Using Gosling's testimony, that of other industry executives, and a trove of Microsoft E-mail, Justice is hoping to show that Microsoft set out to "deliberately destroy the pro-competitive alternative that Java offers," David Boies, Justice's lead trial counsel, recently said in court.

Microsoft is crying foul. Not only are the Java charges ludicrous, it says, but it has not had enough time to prepare for this 11th-hour witness.

Meanwhile, the government is honing its two-pronged attack. It plans to argue that in the early to mid-1990s, Microsoft realized that two developments—Netscape Communications Corp.'s Internet browser and Java—could erode its Windows business. Java was a threat, the government says, because it enabled software developers to write applications that could run on any system on the Internet—to be, in programmer parlance "cross-platform." That approach, if it

use it. Prosecutors allege that, because Netscape uses cross-platform Java, Microsoft's attempts to kill the rival browser were also aimed at harming Sun's Java. Another alleged tactic, according to Sun general counsel Michael H. Morris: If they wanted to keep the coveted "Windows-compatible" logo on their products, developers were required to use the Microsoft version of Java. Justice also will allege that the software giant pressured Apple Computer Inc. to use

Microsoft's version of Java—and Microsoft Internet Explorer—as a condition of getting a \$150 million investment from Microsoft.

"SCREW SUN." Justice intends to use a battery of internal documents to prove that Microsoft intended to "pollute" Java. Much of the evidence was subpoenaed from a California suit in which Sun is charging Microsoft with breach of contract. In one document, Microsoft wrote that a "strategic objective" was to "kill cross-platform Java." In a 1997 E-mail, a company engineer wrote: "Screw Sun, cross-platform will never work. Let's... steal the Java language."

Microsoft argues that its license agreement with Sun allowed it to modify Java—a dispute at the center of Sun's suit. And rather than setting out to harm cross-platform Java, Microsoft says it sought to improve the technology. Software writers opt for Microsoft's version because it works better with Windows, the company says. Now, it's up to Judge Thomas Penfield Jackson to decide who's right.

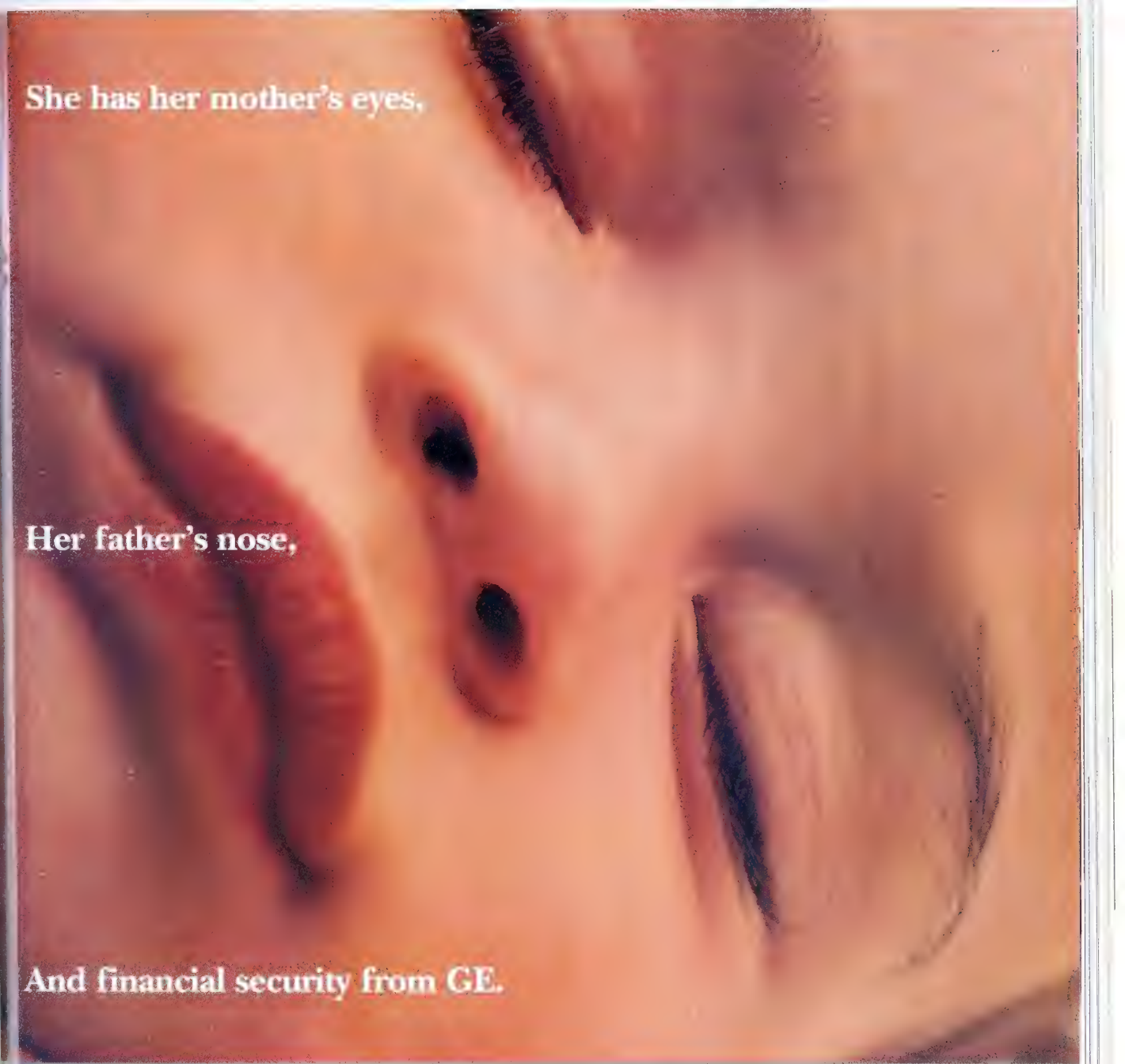
By Susan B. Garland in Washington



TAKE THAT: Sun's Gosling creams a Gates look-alike

caught on, might make Windows—or any other operating system—less important: Software writers would write for Java, rather than specifically for Windows, as they do now.

The Justice Dept. will argue that Microsoft set out to destroy Java's key advantage—its ability to run on all kinds of hardware, not just Windows machines—by licensing Java, then creating a Windows-only version and coercing software developers to



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WORKPLACE

GLIDING TOWARD A LABOR UNION?

American's ticket agents are set to vote on joining the CWA

Since taking over as CEO of American Airlines Inc. in May, Donald J. Carty has made a point of improving labor relations. From relaxing the summer dress code for office workers to sweetening travel benefits, he has looked for ways to end the bad blood between labor and management at American, which weathered two strikes in the past five years. On Sept. 29, Carty assured analysts that relations with nearly every major employee group were good or improving—in contrast to the turmoil at Northwest, United, and Delta.

Nearly, but not all. On Oct. 8, after almost a year of effort, the Communications Workers of America filed with the National Mediation Board to hold a national election at American to represent airport and reservations agents. Organizer Sandy Rusher claims that more than 50% of the 15,000 agents have signed cards in support of the CWA, well north of the 35% needed to request a vote. This is the first time in 20 years a union believed it had enough support with these workers to call for a vote.

The unionization drive could be Carty's first big labor challenge since taking

KEEPING COOL: *CEO Carty wants a "cultural revolution"*

over as CEO. It comes just as the economy is slowing down and American is trying simultaneously to contain costs and improve customer service. "We have been pursuing a cultural revolution here," says Daniel P. Garton, recently named senior vice-president of customer services. A

vote to unionize, he says, "obviously would be a bit of a setback."

The goal for Carty is to fend off the union without alienating employees. "It's a very tricky line he's going to have to walk," says Denise Hedges, president of the Association of Professional Flight Attendants, which just began contract talks. And Carty could face a tough battle: 19,000 agents at United and 9,000 at US Airways recently voted to unionize and are seeking their first contracts.

FED UP. American intends to resist. In late July, the airline sued the union for unauthorized use of its logo. And in an Oct. 9 letter signed by Carty, American warns agents that the CWA wants them for their dues and can't guarantee any results. Garton says American is simply providing "all the information, in as unbiased a fashion as possible."

But some agents say they're fed up with years of one-sided pay and benefits changes. "There is so little trust," says 22-year agent Sally Ann Fowlkes. American boasts the highest maximum pay in the industry for agents, \$19.66 an hour, but it's the only major carrier that doesn't specify the years needed to reach that level. Another thorny issue: a two-tier pay scale under which agents hired since 1996 top out at \$13 an hour.

American believes it still has a good chance to keep the agents out of the union fold. But if it loses? "We will develop a relationship with the union leadership and the employees who are part of that union," says Garton, "but it will be more difficult." Then Carty's new culture at American will really be tested.

By Wendy Zellner in Dallas

DETROIT

A GREAT TIME TO BE FLUSH

And cash-rich Ford is plotting an acquisition strategy

There may be a liquidity crisis in some parts of the world, but not in Dearborn, Mich. Ford Motor Co. is sitting atop a \$23 billion mountain of cash—a handy stash when there are some well-priced prizes to be had. All that cash—nearly twice its pile three years ago—"gives us a lot of options," boasts Ford Chief Executive-designate Jacques A. Nasser. And he and the company's new chairman, William Clay Ford Jr., plan to exercise some.

That should make Wall Street happy. Analysts say the company can afford to spend \$4 billion to \$5 billion and still have plenty left over to weather the next downturn, particularly since Nasser has slashed costs by \$5 billion since 1996. Even deducting debt, Ford has an imposing \$13.1 billion in net cash. On Oct. 1, Ford shared a sliver with investors by upping the quarterly dividend 9.5%.

But Nasser and Ford have much bigger plans. The first: a renewed bid for Korea's Kia Motors Corp. On Oct. 12, Ford resumed bidding for Kia after creditors agreed to reduce the amount of Kia's \$9.5 billion debt that must be assumed. Ford, anxious to boost its paltry 1% Asian share, is bidding against Korea's Hyundai Motor, Daewoo Motor, and Samsung Motor, with a winner to be selected Oct. 19. Ford's balance sheet and accelerating earnings—profit climbed 10% in the third quarter, to \$1 billion—make it a serious contender.

Wall Street would like to see Ford set its sights higher. The real trophy: luxury European auto maker. Chrysler Corp.'s pending merger with Daimler-Benz is the new global automotive model. "Ford might want to mimic the brethren at Chrysler and hook up with BMW or Volvo," says Merrill Lynch Co. auto analyst Nick Lobaccaro. BMW and others insist they are not for sale, but Ford executives rule out nothing. Says Nasser: "We never say never."

For now, Nasser and Bill Ford seem almost giddy. Says Ford: "It's nice to have the flexibility to chart your own future." With global economic turmoil cutting prices, there appears to be a foreign deal in Ford's future.

By Keith Naughton in Dearborn

Workers' gripes include a lower cap on salaries for post-1996 hires

Netscape

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NETSCAPE

By Peter Coy

THE MOTHER TERESA OF ECONOMICS

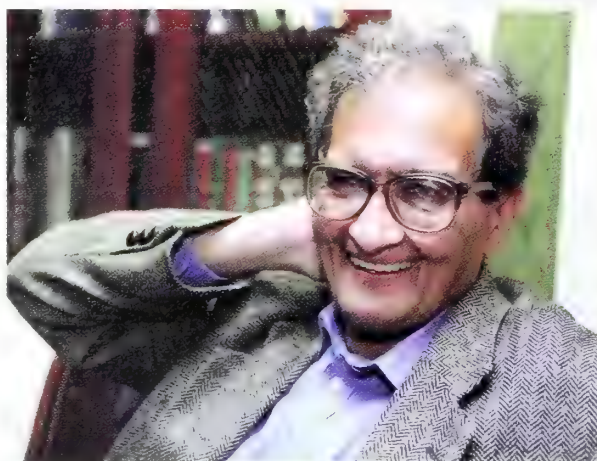
You can say this for Amartya K. Sen, the latest Nobel laureate in economics: He's less likely than the 1997 winners to imperil the world financial system. Last year, the award went to Myron S. Scholes and Robert C. Merton of Long-Term Capital Management, the overleveraged Greenwich (Conn.) hedge fund that might have brought down the banks like a house of cards if the Federal Reserve hadn't engineered a \$3.6 billion private rescue.

In honoring Sen, an Indian-born economist whose work focuses on the plight of the world's poor, the Nobel committee might have been trying to atone for the LTCM debacle. After all, the Nobel imprimatur likely helped the firm borrow long after other speculators would have been cut off.

"DEEP CONCERN." Sen, in contrast, is economics' answer to Mother Teresa. "There's a very, very strong moral thread that runs throughout his work. He has a deep concern in his work for people and human dignity," says David E. Bloom, who taught a course with Sen at Harvard University. Says Sen: "I've spent most of my life working on the downside of economics."

Sen was first intrigued by economic problems when, at age 9, he handed out tins of rice to victims of starvation in Bengal. Years later, he concluded that a shortage of food is only rarely the cause of famines. Rather, the problem is that the poorest people don't have the money to buy what food there is. Says Debraj Ray, a development economist at Boston University: "It's not a novel understanding that famines can be caused by market failure. But Sen was the one to pound it down the throats of people."

Sen's guiding principle is that



THE BOOK ON AMARTYA SEN

BORN 1933, Shantiniketan, Bengal, India

EDUCATION B.A., University of Calcutta, 1953; B.A., Cambridge University, 1955; PhD, Cambridge University, 1959

CAREER Taught at several universities in India, Britain, and the U.S., including Harvard University. Currently Master of Trinity College at Cambridge University

IDEAS Specializes in social choice theory, economic inequality, and economic development. Showed that in most famines there is an adequate food supply, but people starve for lack of money to buy it. Demonstrated mathematically that attempts to measure economic inequality inevitably involve value judgments.

PERSONAL Married to economic historian Emma Rothschild; four grown children

well-being can't be measured only by wealth. It's a point that he says is an old one, but has been neglected by many economists. Sen provided some of the intellectual inspiration for the United Nations' Human Development Index, which ranks nations according to life expectancy at birth and educational attainment in addition to per-capita income.

Sen hasn't been afraid to criticize the failings of the developing world. In 1992, he called attention to the 100 million "missing" females in parts of Asia, where parents who prefer male children have aborted, killed, or starved baby girls. He has also

heaped scorn on claims by Asian leaders such as former Singapore Prime Minister Lee Kuan Yew, that freedom is a Western value not suited for Asia and Africa.

Taking care of society's most vulnerable isn't just an ethical mandate, Sen has taught. It's also good for business. He argues that one reason India's economic growth has trailed China's is that India has failed to educate its masses. And he blames the current developing-world economic crisis largely on leaders who failed to prepare their populations for the global economy.

Sen also made contributions to more theoretical areas of economics, largely building on the work of American Nobel laureate Kenneth Arrow. In one paper, he advanced social-choice theory, proving mathematically that it is impossible to achieve a state of "Pareto optimality"—a measure of societal satisfaction—while also fully respecting each person's right to freedom of action.

Earlier this year, Sen left Harvard after 10 years to become Master of Trinity College at Cambridge University, where he received bachelor's and doctoral degrees. At 64, he hopes to relax a bit. "Wine is not a subject in which I lack interest," he told a British interviewer.

The name Amartya was given to Sen by Bengali poet and Nobel laureate Rabindranath Tagore. It means "one who deserves immortality." By forcing economists' attention on the problem of poverty, Sen has lived up to his name. His work is a welcome contrast to that of last year's winners. And, sadly, given the human devastation in which hot-money capitalism played a part, Sen has become very much a man for our time.

Coy is associate economics editor

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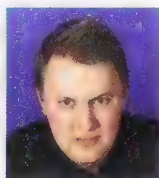
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Barry Arikio,
Executive VP and COO,
Netscape Communications



Stan Davis,
Senior Research Fellow,
Ernst & Young's Center
for Business Innovation



Christopher Meyer,
Director, Ernst & Young's
Center for Business
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Forum speakers will vary depending on location

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co-authored by
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NETSCAPE®



EDITED BY KELLEY HOLLAND

BANKAMERICA GETS BURNED

NATIONSBANK AND BANK-America had months to scrutinize each other while their merger was pending, but BankAmerica still had some surprises on its books. On Oct. 14, just two weeks after the merger closed, BankAmerica said it would charge off \$372 million in the third quarter to cover an old BofA investment in D.E. Shaw, a New York trading and investment firm. That, and losses in emerging markets, pushed down profits from operations by 50%, to \$893 million. Even after the charge, BankAmerica says it has a \$1 billion investment in Shaw and another \$400 million in hedge-fund exposure. What's more,

the bank says it will "restructure" its relationship with Shaw by buying \$20 billion in fixed-income securities—and "related hedge positions"—from its partner. Says a BofA spokesman, "We are still very enthusiastic about the potential for the franchise."

BELL ATLANTIC'S PACIFIC EXPOSURE

RING-RING: ASIA MELTDOWN calling. On Oct. 13, Bell Atlantic surprised Wall Street by revealing the depth of its exposure to problems in Asia. The Baby Bell, which serves New England and mid-Atlantic states, had invested in Asia in the early 1990s. Now, it plans to take a \$545 million charge to write down its investments in Thailand's TelecomAsia and Excelcomindo in Indonesia. Bell Atlantic will also take a \$500 million charge for an early retirement program. The charges will likely eliminate earnings for the third quarter.

A PARTIAL VICTORY FOR SEA TURTLES

THE WORLD TRADE ORGANIZATION ruled on Oct. 13 against a U.S. import ban on shrimp caught in nets that also ensnare endangered sea turtles. But the case will not stop the U.S. or others from trying to enforce such environmental rules. Indeed, the WTO panel which went against the U.S. on technical issues, upheld the right of countries to waive WTO rules to protect health, safety, or the environment. Now, the U.S. can rewrite the rule, negotiate with plaintiffs, or pay compensation.

ANOTHER HEDGE FUND GETS TRIMMED

YET ANOTHER HIGH-FLYING hedge fund has come back to earth: \$1 billion Ellington Cap-

HEADLINER: JOHN STAFFORD

AMERICAN HOME STILL WANTS TO COHABIT

That's strike two for American Home Products Chairman John Stafford. On Oct. 13, American Home and Monsanto called off their planned \$35 billion merger. The move comes less than a year after AHP's deal fell apart with SmithKline Beecham. In a terse joint statement, AHP and Monsanto said the deal was "not in the best interest of their respective stockholders."

Contrasting styles probably played a role as well. Stafford, 60, exercises tight financial controls while Monsanto Chairman Robert Shapiro has been spending big to build up the compa-

ny's biotech agriculture and pharmaceutical businesses. "Monsanto and American Home are [at] opposite ends of the spectrum," says J.P. Morgan Securities analyst Carl Seiden.



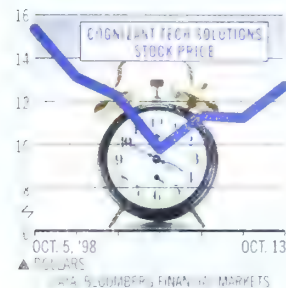
Will Stafford try again? There's talk in the industry that SmithKline chief Jan Leschly may be preparing to exit, which could lead to new talks between SmithKline and AHP. A SmithKline spokesman says Leschly has no plans to resign. But others are also looking for deals. DuPont, for one, wants to build up its pharmaceuticals business.

By Amy Barrett

CLOSING BELL

STILL TICKING

The Year 2000 bug has been good to companies that help avoid it. But what will happen to them after the millennium? Not to worry. On Oct. 13, Cognizant Technology Solutions announced unexpectedly strong earnings for the quarter ended Sept. 30, whereupon its stock rose 15%, to 12 1/2%. Cognizant expects revenue to jump 120%, from \$7.1 million a year earlier, says CFO Gordon Coburn, in part because Y2K customers have been asking the company to take on other tasks.



ital has incurred large losses on mortgage-backed securities. Fund manager Michael Vranos also lost heavily in 1994 when he headed Kidder Peabody's mortgage-backed trading unit. This time around, Vranos held a fire sale starting Oct. 11 for \$1 billion in securities to meet his margin payments. The fund borrowed to control securities worth about \$5 billion. "Ellington took these actions to protect its investors," says a spokesman.

THE PORTALS PROBE: A SERIOUS STEP?

A NEW DOOR IS OPENING IN the Portals office-building controversy. Representative Joe Barton (R-Tex.), chairman of a House investigations subcommittee, intends to refer former Senator and now Ambassador to China James Sasser and three other Democrats to the Justice Dept. for possible criminal

prosecution. The move stems from a probe of the Portals complex, built to house the FCC. Sasser advised the developer, Franklin Haney, Representative Barton says \$1 million in payments to Haney to Sasser and Clinton Gore campaign manager Peter Knight may have been illegal contingency fees. Barton also alleges that both men may have lied under oath to conceal the payments' true nature. All deny wrongdoing.

ET CETERA...

- Cendant's \$3.1 billion acquisition of American Bank Insurance was called off.
- Primestar abandoned its bid for the satellite slots of News Corp. and MCI.
- Apple Computer's fourth quarter earnings topped Wall Street forecasts.
- Caterpillar Chairman and CEO Donald Fites will retire in early 1999.

EDITED BY LEE WALCZAK

THE 105TH CONGRESS: HOW THE REPUBLICANS BLEW IT

As the book slams shut on the vocal, vapid, and venomously partisan 105th Congress, this much seems clear: Armed with fat media budgets and a cadre of better-than-average candidates, Republicans stand to do well on Nov. 3. So why aren't they smirking? Because whatever gains Republicans rack up in the elections will be made in spite of—not due to—their legislative performance on Capitol Hill.

The 105th, which President Clinton is already bashing as a monument to do-nothingism, started off swimmingly. Last year, Republicans and Democrats passed the Balanced Budget Act and sat back to watch the federal surplus—and their approval ratings—soar. Then it all went downhill. This year, Congress became a legislative boneyard. An anti-smoking bill, campaign-finance reform, revision of bankruptcy law, and an attempt to revamp financial industry regs all died. Fast-track trade negotiating authority fizzled, as did attempts to give patients more leverage against managed-care combines. And the big GOP tax bill? It expired in the Senate before Clinton could uncap his veto pen.

To understand this mess, it's necessary to reprise the strategy shaped by House Speaker Newt Gingrich and Senate Majority Leader Trent Lott. The plan had three key elements: Veer from cooperation to the polarization that fires up red-state right-wingers; give GOP candidates an issue by forcing the President to veto a tax cut; provoke the White House into giving conservatives with vetoes of abortion restrictions and environmental curbs a scheduled end-of-year money bill. Although it wasn't part of the grand design, when Monicagate bounced their way, Gingrich and Lott vowed to play it smart. They promised a dignified GOP probe, with talk of impeaching Clinton until '99.

ENDING SQUABBLE. Each of these strategies has come undone. Take the GOP's vanishing tax cut. Responding to firebrands' calls for a big tax bill to ease the "marriage penalty" joint filers, Gingrich pushed an \$80 billion plan through the House. But he ignored warnings from Senate Republicans that the votes weren't there for a costly tax measure—mainly because Clinton would nail the move as a reckless run on Social Security. On Oct. 9, the bill died in the Senate.

We're learning that if you're a majority, you've got to seek consensus early on," says Representative Marge Roukema (R-N.J.). But Gingrich shows no sign of letting up the pressure. Next year, he aims to come back with a huge rate cut that would dwarf this year's \$80 billion package.

Republicans also managed to bungle the spending showdown with the White House. Because squabbling House and Senate committees got way behind schedule, a plan to swamp Clinton with a half-dozen appropriations bills—each lined with special provisions for hardliners—never materialized.

Instead, Republicans once again confronted the disastrous possibility of a government shutdown. To make matters worse, Clinton scored big by portraying the dispute as a lofty fight for his education initiatives. In the end, GOP leaders stripped off pet riders and gave the White House a victory. Says University of Virginia political scientist Larry Sabato: "Republicans seem incapable of grasping the fact that any President has more leverage than they do."

Republican leaders' handling of the Clinton scandal hasn't fared much better. After Independent Counsel Kenneth W. Starr lobbed his report to Congress on Sept. 2, the idea was for House Judiciary

LOTT AND GINGRICH

They had a plan. They just didn't stick to it.



CASUALTIES ON THE HILL

TOBACCO A \$600 billion plan dies in the Senate

TAXES No go on \$80 billion in "pro-family" tax cuts

PATIENT BILL OF RIGHTS A compromise comes to grief as conservatives balk

TRADE House nixes fast-track trade negotiating authority

FINANCIAL-SERVICES REFORM Is thwarted by last-minute Senate objections

CAMPAIGN FINANCE Passes House, withers in the Senate

Committee Chairman Henry J. Hyde (R-Ill.) to be the voice of reason on impeachment. But soon, discipline broke down as angry House conservatives called for Clinton's scalp.

The result: The public has overwhelmingly turned against the Republican inquiry, branding it partisan overkill. In a *Washington Post* poll released on Oct. 12, 62% of those surveyed disapproved of the GOP's handling of the impeachment probe. More ominously, Congress' favorable rating has dropped from 52% to 45%. "Republicans made themselves look foolish," says Steven S. Smith, a University of Minnesota political scientist. "Their handling of the [scandal] has now become the issue."

In fairness, Republicans had their moments during the fractious 105th. Gingrich and Lott claim, with reason, that Clinton would never cut the balanced-budget deal

without unrelenting GOP pressure. Similarly, a series of superbly staged hearings enabled Republicans to push their plan for an overhaul of the Internal Revenue Service past White House objections.

What those triumphs have in common is that they occurred a long time ago, before the wheels fell off of the congressional locomotive. Now, Republicans are looking at the midterm elections without a unifying platform, such as 1994's Contract With America. All that's left is the 105th's Contract With Chaos—and few pols think it will be enough to propel the party to the crushing November sweep Gingrich and Lott once envisioned.

By Amy Borrus

CHINA

RED CHIPS NO MORE

Beijing learned a costly lesson from the collapse of two investment trusts

Larry Yung was the shrewd operator, amassing a multibillion-dollar portfolio in Hong Kong blue chips and hobnobbing with the money elites of Asia and Europe. Huang Yan-tian lived more on the edge, a former party official turned wheeler-dealer who cruised the streets of Guangzhou in a silver Lexus and knew how to get around Beijing's dictates. As the guiding lights behind two of China's most entrepreneurial financial institutions, Yung and Huang presented different faces of red capitalism. But both were golden in the eyes of Western banks and investment houses that threw money at their firms—CITIC Pacific Ltd. and Guangdong International Trust & Investment Corp. (GITIC)—during China's go-go years.

No longer. As details emerge of the financial missteps at Yung's CITIC Pacific and Huang's GITIC, it's becoming clearer both fell victim to the same delusion: that global capital markets would continue to supply cheap money without asking hard questions. With the Asia crisis gouging earnings at CITIC Pacific, investors are jumping ship, sending the stock down 70% from its 1997 peak. That's bad news for the firm's powerful parent, Beijing's China International Trust & Investment Corp. (CITIC), which derives nearly all its profits from the Hong Kong subsidiary. A controversial bailout from Beijing earlier this year saved Yung from financial ruin. And now, China's Finance Ministry plans to inject \$4.5 billion into CITIC.

Huang wasn't so lucky. On Oct. 6, Beijing authorities, alarmed at GITIC's

staggering foreign debts and reckless management, shut the firm down. Huang, now listed as a GITIC consultant, hasn't appeared in public for months and is under investigation, according to government sources. He could not be reached for comment and apparently has not been charged with wrongdoing.

The travails of Yung and Huang highlight the newest peril to China's economic health. CITIC and GITIC are but two of hundreds of firms, known as trust and investment corporations, set up with the blessings of the late Deng Xiaoping in the 1980s to help central and provincial governments raise foreign funds and invest in strategic projects. But as wealth and a taste for risk-taking grew, these firms made billions in bad bets on dubious real estate projects and stock plays. By some estimates, half their \$55 billion in assets are nonperforming. Investment trusts have run up big, unhedged, short-term foreign currency debt from offshore lenders and bond investors. They've also been among the heaviest borrowers from China's four domestic banks. "If the investment trusts go down, then the banks are in trouble," says China finance expert Nicholas R. Lardy of the Brookings Institution.

NO GUARANTEES. Now, foreign bankers and rating agencies are wondering where the crackdown will lead and what it means for the financial sector. Unlike China's big state-owned domestic banks, investment trusts such as GITIC relied on foreign-currency loans for some 70% of their borrowing, according to Moody's Investors Service, and Beijing may not back all of them. Until the onset of the Asia crisis in mid-'97, it was easy for them to raise foreign funds.

At the same time, Beijing bureaucrats who thought they were safe from the Asian contagion are learning that China's exposure to foreign borrowing is

greater than they thought. What's more, many funds borrowed by investment trusts in Guangzhou, Shanghai, and other cities have been plowed into risky investments like office towers and luxury apartments. Many local governments who control the trusts can't afford to bail them out if bets go sour, according to Moody's.

By shutting down GITIC, Premier Zhu Rongji is sending a message to local officials and their foreign lenders: No one is so powerful that his survival is guaranteed. In 1997, authorities shut down the China Agribusiness Development Trust Investment Corp., which had engaged in massive property speculation in Hainan Province. Earlier this year, Beijing shuttered a Hainan bank. To many observers, that's encouraging news, since it suggests that China is starting to discipline profligate financial institutions.





Woes for Chinese Capitalism

CITIC was once the flagship of China's capitalism, with big stakes in booming Hong Kong, and the darling of Western investors



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CITIC'S CHIEF
Wang says a bank-
ruptcy would hurt
the whole Hong Kong
stock market

In CITIC's case, the beginning of the trouble came when Wang Qishan, Zhu's right-hand man and the former head of China Construction Bank, assumed

No.2 slot in Guangdong's government last year. Wang took one look at CITIC and was alarmed. Investigators found that CITIC had about \$3.6 billion in debt, some \$1.6 billion of it in foreign currencies. The bulk was short-term loans. CITIC's Hong Kong units owed a further \$850 million. Plus, CITIC had guaranteed \$3 billion in loans—almost five times its capital.

ICY TASTES. When cash-strapped Japanese and Korean banks began recalling credit lines, Guangdong raised \$1.7 billion to try to rescue CITIC, according to a Beijing newsletter. But Zhu decided in October to shutter CITIC and put it under the management of the Bank of China.

Perhaps more surprising are the doubts at the biggest red-capital-creation of them all—CITIC. Made from Hong Kong's CITIC Pacific, the sprawling Beijing conglomerate is an ill-focused collec-

tion of weak companies that span banking, energy, communications, mining, advertising, and property. Last year, it earned \$1.4 billion on assets of \$26.7 billion, almost entirely from CITIC Pacific or the sale of the unit's shares. Supervision of the company now is shifting

from the State Council—China's cabinet—to the central bank, which analysts say will exercise firmer oversight.

Just a few years ago, Yung and CITIC Pacific were the toast of China Inc. The scion of an old Shanghai business family and son of China's recently retired Vice-President Rong Yiren, Yung had the pedigree to put both communists and capitalists at ease. During the past decade, he turned his tiny Hong Kong shell company into a multibillion-dollar empire with big stakes in Cathay Pacific Airways, China Light & Power, and a huge Hong Kong residential complex.

He also had expensive tastes. In 1993, Yung paid \$8 million for a 700-acre estate in Sussex, England, once owned by former British Premier Harold Macmillan. A steward of the Hong Kong Jockey Club, Yung once won \$5 million at the track—and pledged it to Stanford University, where his daughter studied.

Yung also was adept at raising funds through equity and bond offerings. Investors liked that, unlike his compatriots, he bought into sound companies rather than plunging into dodgy asset plays. CITIC Pacific also hired top professional managers.

FADING GLOW. But something went badly amiss. CITIC Pacific's stock has fallen more steeply than the rest of the Hong Kong market. Yung has taken a beating as well. In early 1997, he bought a 15% stake in the company. At the time, it was a terrific deal: The shares were bought at a \$475 million discount to the market price. Analysts suspect Yung borrowed the money for the purchase, using the shares as collateral. But when CITIC Pacific's stock started diving, rumors swept Hong Kong that banks holding

Yung's stock were ready to dump them. That sent CITIC Pacific shares down even further. Before long, Yung's sweetheart deal turned into a \$1 billion paper loss—and Wang Jun, CITIC's chairman in Beijing, stepped in with financial aid.

As the glow from the China magic fades, analysts are focusing on CITIC Pacific's dismal business basics. Earnings fell 71% in the first half of 1998, and a quick rebound is unlikely. Cathay Pacific will post its first-ever loss this year. Servicing CITIC Pacific's \$3.5 billion in debt is becoming difficult because of weak cash flow and its inability to float new share offerings.

The failure of its premier red chip would be enormously embarrassing for Beijing. That's why it's bailing Yung out. "If they go bankrupt, it would have a major impact on the

The Risks to the Big Trusts

UNHEDGED FOREIGN EXCHANGE EXPOSURE

Some 70% of the big trusts' borrowings are in foreign currency. If China devalues, the damage to the trusts would be huge.

TOO MANY REAL ESTATE LOANS

The trusts of Shanghai, Guangdong, and others are big property developers and lenders—just when real estate is slumping.

UNKNOWN LEVELS OF PROBLEM LOANS

The big trusts are probably substantially understating the weakness in their portfolios.

GOVERNMENT BAILOUTS ARE NOT GUARANTEED

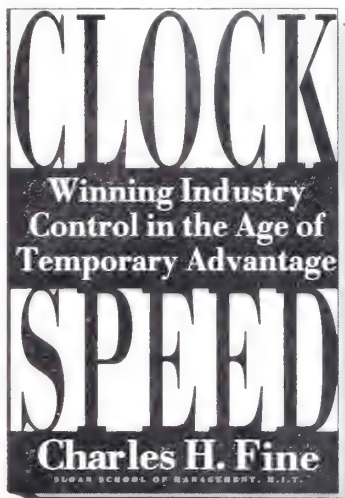
If too many trusts start to go under, local governments may lack the funds to prop them up.

DATA: BUSINESS WEEK, MOODY'S INDUSTRY OUTLOOK

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entire Hong Kong stock market," says Chairman Wang. The parent is also buying back as many of its shares as it can.

Beijing's intervention also raises concern about the lack of transparency at red chips. Even though CITIC Pacific is listed in Hong Kong, many questions remain about Yung's share purchase and his bailout. Yung declined BUSINESS WEEK's interview requests. Investors are getting fed up: CITIC Pacific now trades at less than two-thirds of the value of the assets in its portfolio.

Yung's operation is not the only headache for the parent company. Take its investment in Hong Kong's CITIC Kwong Wah Bank Ltd. Jin Deqin, the bank's former chairman, is under investigation for a \$1 million loan to his son. Wang says Jin is also being investigated in a



graft case involving suspected misuse of CITIC funds. Jin was arrested in April and could not be reached for comment.

If China's brightest stars can get into such trouble, it's fair to expect more bad news. Shanghai's big trust company is heavily exposed to the property market at a time when vacancy rates are high. Investment trust for the city of

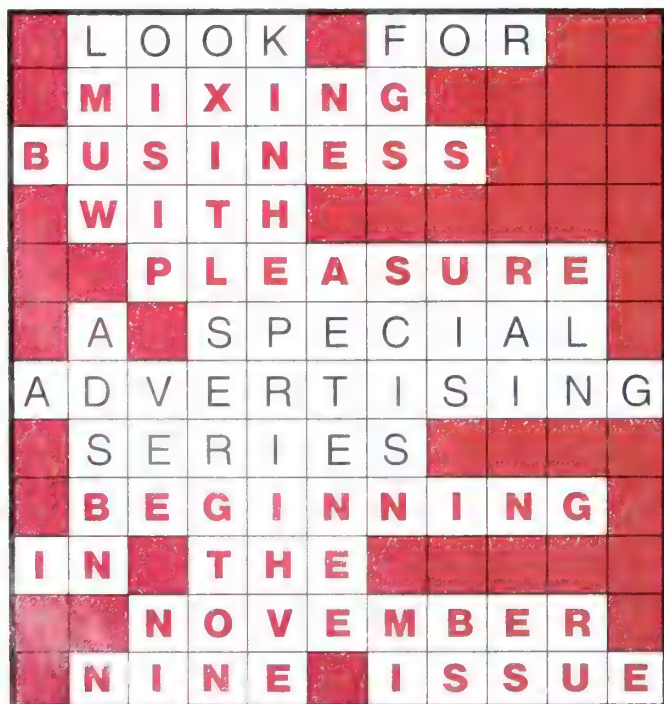
THE TYCOON

A former party official, Huang remade himself as a master dealmaker

Tianjin and the provinces of Fujian and Shandong also carry big debts. Beijing is reducing the number of such vehicles. At their peak the country boasted more than 70 trusts. Now, there are less than 25. Hoong Yik Luen, head of China research at ING Barings Ltd., predicts "eventually they will be closed, one by one."

If that's the case, the face of China's financial system could change dramatically. By reducing fast-footed dealmaking at the local level, Beijing could also more easily clean out the rot and ensure lending follows global norms. But if companies assumed to have government backing go under, foreign investors will have to reassess the creditworthiness of all Chinese borrowers. Confidence in China's financial system would be shaken. For China's freewheeling red capitalists, the end of an era is at hand.

By Mark L. Clifford and Joyce Bonathan in Hong Kong, with David Roberts in Beijing

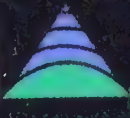


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JAPAN

THEY'RE SLEEK, LIGHT, CHEAP —AND JAPANESE

Suddenly, computer makers are turning out snazzy portables

It was very Zen advice. In 1995, Sony Corp. President Nobuyuki Idei talked to Intel Corp.'s Andrew S. Grove about his plans to make personal computers. Sony computers, replied Grove, should be "Sony-like." Sony's efforts in 1996 and 1997 didn't elicit much comment from Grove. But this July, says the Sony chief, Grove congratulated Idei for "finally making a distinctive PC". The product that had caught his eye: Sony's new VAIO C-1 with a built-in digital camera, an "ultraportable" that blurs the line between notebook and handheld PC and has the sort of joyful, "gee-whiz" feel of Sony's best gadgets.

Sony is helping stir up a new buying frenzy in Japan for notebook computers weighing an ultralight 2.2 pounds. Sharp, Matsushita Electric Industrial (Panasonic), Toshiba, and Fujitsu are joining the fun. All are introducing machines that are the thinnest and lightest ever to come on the Japanese market at the lowest prices ever. It's not clear if this newest wave of products will wow U.S. buyers, who must wait a few months to test most of the latest notebooks. But the new gizmos show the Japanese still have world-class ambitions.

POWER-PACKED. To strip out weight, Sony and others have shrunk the size and weight of lithium-ion batteries, hard-disk drives, liquid-crystal-display screens, and other devices. Mostly equipped with Pentium processors with MMX technology, the new generation packs as much power as its heftier notebook predecessors for the same price or less—about \$2,000 to \$3,000. The combination of price and portability

seems to have struck a chord with consumers. The notebooks should drive a 5% spurt in overall PC shipments this year, even though desktops are not doing well, says Ichiro Mitsuda, assistant supervisor of Sharp Corp.'s personal and mobile computing systems unit. "We can't keep our ultralight notebooks in stock," he adds.

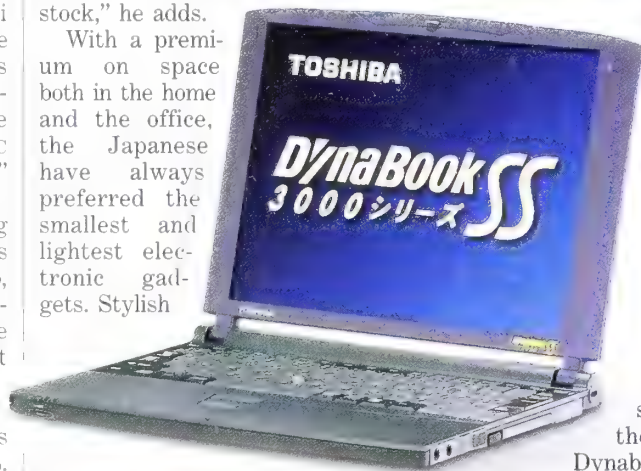
With a premium on space both in the home and the office, the Japanese have always preferred the smallest and lightest electronic gadgets. Stylish

packaging is another factor fueling demand. "Until now, [these products] all looked the same," says Takashi Fujimoto, a 43-year-old insurance agent who last month purchased his first notebook, the VAIO 505. "What decided me was the great design." His model has a mauve and silver molded magnesium case, measures just 10 inches by 8, and

has a surprisingly wide keyboard.

Sony's charge has provoked a wave of innovation in the market. Sony has just released a "memory stick" PC card the size of a stick of chewing gum. It can download data from its digital video and still cameras into a VAIO for easy editing and storage. Its PC Glasstron looks like something out of the movie *Blade Runner*. Glasstron's virtual-reality goggles function as an LCD monitor: When the goggles are connected to a VAIO portable, users can view images on a virtual large screen.

Not to be outdone, Toshiba has shrunk its latest Libretto to a featherweight 1.8 pounds by using the world's thinnest hard-disk drive—just a quarter-inch thick. It uses the



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Very thin magnesium sheets are used to encase this line of notebooks

thinnest magnesium sheets available to encase the Libretto and its new

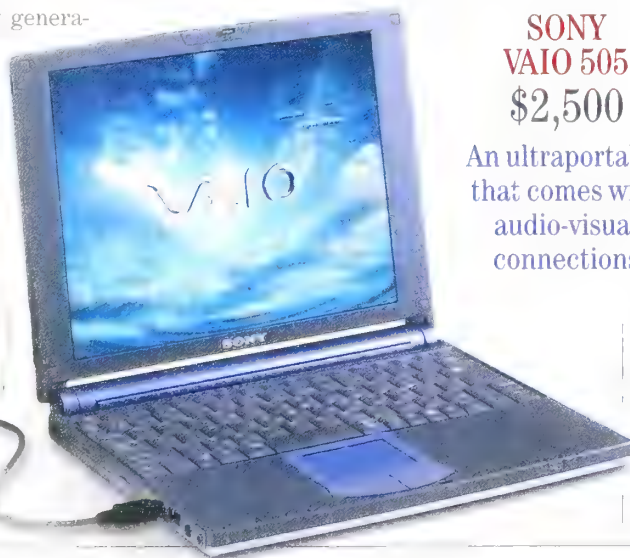
Dynabook line of notebooks.

It's all hot stuff, but will it play in the U.S.? In Japan, people buy these products as primary computers, often at home. In the U.S., mini-notebook and handhelds are bought mostly as mobile companions to desktop machines, usually in the office, but the Japanese notebooks are not really designed for that purpose. Besides, IBM and others are making much more portable full-sized laptops these days. Though an earlier version of Toshiba's Libretto could not duplicate in the U.S. its success at home. And Sony has not had a home run yet selling earlier VAIO models to the U.S. market.

But at least American computer makers competing in Japan are taking notice. "We're putting the priority on making new notebooks for the Japanese market,"

Takashi Oka, head of PC sales for Compaq Computer Corp. in Tokyo, told reporters last week. "If we don't, we won't be able to keep up with our Japanese competitors." Thinner, faster, and at long last cheaper: The Japanese are learning.

By Irene Kunii in Tokyo



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EUROPE

HOW FAR LEFT?

Business fears Europe's new leaders will derail reform



DISHEARTENING: Schröder's tepid tax plan worries many

It was hardly the debut that business had hoped for. On Oct. 11, the leftist coalition of German Chancellor-elect Gerhard Schröder announced a tax plan so tepid as to be ineffectual. Although personal and corporate tax rates will technically fall, the drop will phase in over three agonizing years. Meanwhile, the plan closes so many business tax loopholes that companies are likely to come out losers.

The move sent a disheartening signal to those anxiously wondering which way Europe's left will tilt in setting policy. Self-styled center-left governments now control 13 European nations. In good economic times, the centrists have held sway. But in a climate of slowing growth, Schröder and French Prime Minister Lionel Jospin face a credibility crisis. Elected on promises to reverse chronic unemployment that hovers around 11.5%, they must cover their flanks on the left or watch their popularity erode. Business fears that under such economic and political pressure, Continental Europe will drift toward high government spending, delay reforms, and remain indifferent to the plight of companies already squeezed by sky-high costs.

Unlike the Labour government of British Prime Minister Tony Blair, the

French and German leaders have radical coalition partners to satisfy. Jospin must contend with Communist and Green party members who are demanding greater social gains. Schröder, meanwhile, faces pressure for leftist economic solutions from former party chief Oskar Lafontaine, his appointee for Finance Minister. "Lafontaine and Jospin are two key figures who could be seen tilting to the Old Left," says Jonathan Story, professor of political science at INSEAD, the management school in Fontainebleau.

Already, signs of newfound belligerence from the left are popping up on the Continent. On Oct. 9, the government of Italian Prime

Minister Romano Prodi was toppled by radical Communists who wanted more social padding in the 1999 budget. The Communists bowed out of the coalition when Prodi returned to power. But Prodi and Jospin are lobbying EU officials in Brussels for a huge, Europe-wide infrastructure or technology program to create jobs and stimulate demand. And on Oct. 13, French Finance Minister Dominique Strauss-Kahn proposed \$365 million in tax cuts for home improvement—to be partially offset by closing corporate tax loopholes.

Outside of government, traditional supporters of the left are feeling their oats. IG Metall, Germany's largest union,

is demanding a 6.5% pay increase in its next contract. Experts expect it to settle for 3% or less, but that would still be a major hike from the 2.5% and 1.5% it accepted in 1997 and 1996—especially since Germany's recovery is looking shaky. In France, demonstrations in two southern towns calling for more public spending on high-school teachers and supplies have snowballed into a national movement, with students expected to stage a nationwide protest on Oct. 15.

More ominous, if growth slows sharply in 1999 and unemployment creeps up, the left could put political pressure on the new European Central Bank after monetary union formally starts on Jan. 1. Lafontaine already has called for lower interest rates. In France, some politicians are even more direct. "We do not accept the independence of the central bank," fumes Alain Lipietz, the Green party member of Jospin's economic advisory council.

DISCIPLINE. ECB Governor Wim Duisenberg insists his bank will not be influenced by Germany's left or any other politicians. But such outbursts upset central bankers and industry leaders who desperately want the new single currency to be launched with a solid underpinning of monetary discipline. "The stability of the euro is at stake," warns Hans-Olaf Henkel, president of the Federation of German Industry.

Ironically, the French Socialists have actually presided over more privatization, regulatory changes, and other reforms than their conservative predecessors. So a radical swing to the left would be a sorry unraveling of progress to date. Indeed, throughout Europe, the forces of globalization have gradually overcome ideology in the past few years, and the business climate is slowly improving. Now executives can only bite their nails and hope that the so-called new left doesn't undo it all.

By Gail Edmondson in Paris, with bureau reports

How the Left Could Get Pushier

PUBLIC-WORKS SPENDING

Jospin and Prodi are lobbying Brussels for costly, Europe-wide infrastructure projects to fight unemployment.

TAX SHUFFLES

Although probusiness on the surface, Schröder's plan shifts taxes from individuals to companies by closing most corporate loopholes.

WAGE AND BENEFIT DEMANDS

German union IG Metall is calling for big pay hikes. French students are demanding more spending on education.

PRESSURE ON EMU

Ruling parties across Europe could press the new European Central Bank to lower interest rates once monetary union starts.

DATA: BUSINESS WEEK

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HOW QUEBEC'S WILY PREMIER MAY KEEP SEPARATISM ALIVE

ucien Bouchard could give President Bill Clinton lessons in situational politics. The charismatic Quebec premier has dodged between embracing Canadian unity a decade ago and passionately backing independence for Quebec more recently. Now, the wily 59-year-old lawyer will need all his political deftness to win a second term in elections that he is calling early—possibly on or around Nov. 30.

Although he's trailing slightly in polls and separatism is on the wane, Bouchard might hang on to power. He beat back a mid-September attempt by radical members of his Parti Québécois to force a prompt replay of the 1995 sovereignty referendum if he wins. Instead, he is committed only to staging a ballot when he decides that "winning conditions" prevail. The fudge may well make the party more palatable to the majority of Quebecers weary of such referendums.

ECONOMIC UPSWING. Bouchard has nearly closed the gap with his main rival, Jean Charest, the dynamic 40-year-old Francophone leader of Quebec's Liberal Party. Charest, formerly leader of the federal Progressive Conservative Party, quit his Ottawa parliamentary seat last spring after being persuaded that he is the best hope for getting a pro-unity government into office in Quebec City.

Initially, Charest was enormously popular and had an 8-point lead over Bouchard. But now it's far from clear that his coattails are big enough to attract sufficient Liberals to oust the PQ. For one thing, he trails among French-speaking voters outside Montreal. "He is a lefty, and it has taken longer than expected to integrate his group into the party," says Yves-Marie Morissette, a McGill University law professor and Liberal adviser. Charest has tried to focus the debate on issues such as the economy, where Bouchard long looked weak. But that strategy has begun to work against him because Quebec's econo-

my has lately shown surprising signs of life. The provincial gross domestic product grew 2.7% last year and may show similar growth this year—the strongest performance since 1988. Unemployment, traditionally higher than in the rest of Canada, has dropped to 10.2% from a peak of over 13% in 1993 and could fall further, say economists at the Toronto-based Nesbitt Burns brokerage firm. What's more, the PQ government is close to balancing the provincial budget.

Bouchard had to call early elections to extract benefit from those gains. He could have waited until next spring. But by then, Quebec might have fallen prey to the slowdown now threatening all North America. That would have given Charest traction. And Quebecers might have flocked back to Charest simply to try a different approach.

UNEXPECTED HELP. For now, Bouchard seems to be on a roll. Recently, he scored with Francophones by jawboning leading Montreal department stores into shunning bilingual signs an English-speaking group had demanded. Liberals were dismayed by the demand because it "increases nationalist sentiment," complains Clements Mayr, a lawyer who heads the Groupe des 100, a pro-federalist organization.

Moreover, Bouchard and the separatists have gotten help from an unexpected source, the federal Supreme Court. In August, the court ruled that if Quebec were to try to secede, it

would have to negotiate with Canada. For separatists, just getting the idea clear that Canada would have to talk about the unthinkable was a victory.

Today, Bouchard has every interest in playing down secession in order to boost his chances of winning the forthcoming election. By keeping his powder dry, he could be well-armed to fight another day for a sovereign Quebec—from the premier's office.

By Joseph Weber in Toronto



BOUCHARD: *On a roll*

GLOBAL WRAPUP

SUHARTO: THE VISE TIGHTENS

Pressure is mounting on former Indonesian President Suharto over allegations that his family may have hidden as much as \$40 billion in assets overseas, which he denies. While judicial officials interrogate Suharto family members and business partners, the government is overturning rules that allowed them to make huge profits. Three land reforms that benefited family projects were revoked on Oct. 4, for instance.

Finding and collecting any cash will

be hard. Privately, government officials say Suharto did not keep many records. Nor is the Philippines' experience encouraging. After a 13-year official investigation into the alleged hidden billions of former President Ferdinand Marcos, his wife Imelda finally agreed on Oct. 13 to settle a mere \$540 million in claims.

STRIKES IN COLOMBIA

► The austerity measures of the new Colombian government headed by President Andrés Pastrana are meant to cut the budget deficit and reassure

markets as Latin America gets pounded by global investors. But they have set off nationwide strikes by more than a half-million public employees. The strikes have crippled public services and shut down schools and courts.

Workers rejected a government offer of a 14% wage hike for next year, demanding that salaries keep pace with the country's 18% inflation rate. They also want an end to privatizations of state-run industries. The austerity measures are expected to slow growth to less than 3% in 1999.

NO LETUP—AND NO APOLOGIES

Antitrust scrutiny hasn't eased Microsoft's competitiveness

On May 10, Microsoft CEO William H. Gates III was on the phone with Justice Dept. investigators from his family compound near Washington's Hood Canal. He was attempting—unsuccessfully—to head off a federal antitrust suit against his company. Meanwhile, across the continent, executives from Intel and Oracle, a Microsoft rival, landed in New York on a flight from Silicon Valley. The next day, they were to seal their \$250 million investment in Road Runner Group, a high-speed Internet-access service. But the Road Runner people called to say the deal was off. Another bid had come in—from Microsoft—and it was nearly twice as high.

The deal was a coup for Microsoft Corp., giving it the inside track on selling its software for digital set-top boxes to Road Runner. But it was also an unmistakable signal to anyone who thought Gates & Co. might tone down their legendary competitiveness in the face of the government antitrust suit. "Their arrogance is incredible," says an executive on the losing side of the Road Runner deal. "Microsoft wins because it can pull out its checkbook—which is unlimited. That stifles competition and is dangerous to the economy."

Whether Microsoft illegally stifles competition or is merely pugnacious will be determined in an antitrust trial that is set to start in Washington, D.C., on Oct. 19. The company has made occasional efforts to soften its public image and has retreated only from some restrictive licensing terms that had already served its purpose.

Nevertheless, one thing is clear: In the year since the feds sued Microsoft for violating a consent decree, the software maker has not backed off from the aggressive tactics that have made it the most powerful force in the computer industry. If anything, Microsoft is pressing harder than ever, barreling into new markets while tightening its hold

on customers that rely on its PC software. "It's overwhelmingly clear that Microsoft is dialing it up," says Jeffrey Papows, president and CEO of rival Lotus Development Corp.

Unlike other industry leaders, such as Intel Corp. and IBM, Microsoft hasn't even adopted a code of conduct for avoiding antitrust violations. Mike Maples, a former top executive who still does projects for Microsoft, has been asked to look into creating one. "I've thought through it a lot, but I can't find the principles that would mean the world would like us more," he says. "We can't tell people not to be so aggressive or don't compete so hard."

It's extreme capitalism. Even while Microsoft's lawyers hustle to pull together their defense (page 39), Gates is dreaming up ways that his company can extend its reach into new markets far afield from PC software—from elec-

TRIPLE BILL

Geek, visionary, arch-competitor: Intensity, focus—and paranoia—helped Gates build Microsoft. Are they overkill in a company with \$13.9 billion in cash?

GATES IN 1986, 1991, AND TESTIFYING AT THE SENATE HEARINGS IN 1998

tronic bill payments and cordless phones to software for gas pumps, traffic signals, and even TV remote controls. Indeed, when you drink a glass of milk next year, consider this: There's a chance that Microsoft software helped test its purity.

Surprised? You won't be for long. As new President Steven A. Ballmer takes over daily operations, Gates will have more time to plot the company's long-term course. Today, his company is the master of desktop software. Tomorrow,

he wants it to rule the world of information appliances.

Gates's grand vision surfaced in an internal memo called "The End Ahead" that was sent to several hundred executives and employees on Sep. 8 and released to the press on the eve of the trial. In it, Gates lays out his view of Microsoft's challenges. The company must make its software much easier to use—and it needs to extend well beyond the PC to provide the software that will run the tiniest device





d the most powerful computers. Clearly, there's no brake on this train. For Gates, it's business as usual. Indeed, the day the trial starts, he'll be adding off for one of his biannual sabbatical weeks." The message from the court is that there's no easing off the pedal. "We try everything we can to win this business," says Jeffrey S. Raikes, Microsoft's vice-president in charge of sales. Thomas E. Allchin, a senior vice-president in charge of Microsoft's Windows division, even defends the warlike language in internal E-mails—which the Justice Dept. cites as evidence of the company's bullying behavior. "Yes, we're a competitive company," he says. "We don't apologize for that."

MOS. What drives Gates to go full-on in the face of the biggest antitrust investigation since AT&T's breakup in 1984? Paranoia. He has seen leading

technology companies fall off their perches. Topping that list is IBM—the subject of a grueling 13-year anticompetitive probe that ended with no action but a weakened company. Hypersensitive to appearing too dominant, Big Blue instructed employees not to talk about their market share or to define markets for fear that the Justice Dept. would later use their words to prove they owned a monopoly. "You always wondered what the lawyers would say before you would make a move," says Sam Albert, a management consultant who was a marketing manager at IBM for 30 years. "The company tied one hand behind its back."

Gates is determined to avoid that mistake. With Microsoft's desktop PC software market nearly saturated, the company is plunging into all-new territory. And no one at Microsoft is more

aggressive about venturing into new realms than Rick Thompson, the vice-president in charge of the company's hardware division. What was once a side business for the software maker—computer mice and joysticks—has become an important source of new revenue: \$500 million last year.

Microsoft's hardware megahit last year was Barney: The plush talking doll reaped \$50 million in sales. This holiday season brings a veritable shopping cart full of new Microsoft-branded gizmos, including PBS' talking characters Arthur and DW (\$109 each), PC stereo speakers (\$249), a cordless PC phone with messaging and caller I.D. (\$199), a motion-sensing joystick (\$69) for flying and motocross games, and a universal remote control (\$299) that lets you operate all of your home entertainment gear with one device. That

last item could be the company's first baby step into providing hardware for home automation, says Thompson.

A similar pitter-patter of baby steps has been unleashed all across Microsoft. In April, its consumer-appliances group released a \$495 developer kit so that companies that make specialized devices will use Microsoft's pint-size version of its software called Windows CE. Microsoft has snagged more than 100 takers making everything from barcode scanners to factory equipment—none of which will carry the Microsoft brand. Idexx Laboratories in Westbrook, Me., for instance, makes a milk-quality tester for dairies that will be introduced early next year, says Steven Maillet, an Idexx software engineer.

STANDARD. Microsoft is coming from behind, but hopes to convince companies that they don't have to design expensive specialized software to run each new machine. Indeed, Microsoft hopes to recreate the dynamics of the PC market, where Windows became a standard that helped hundreds of hardware and software makers create products more efficiently—while making Microsoft the most richly valued company in the world. Wall Street's Dain Rauscher Wessells estimates that the market for such software will top \$2.3 billion by 2001.



NAME GAME "In the middle of this antitrust investigation, Microsoft was trying to steal our brand"

FORMER PALM CHIEF DUBINSKY

Some of these devices may tap into services Microsoft is creating on the Internet. One potentially lucrative effort is TransPoint, an electronic-billing service that Microsoft is developing with partners. Later this year, they plan on launching nationwide service involving a handful of banks and a host of billers. TransPoint will charge the billers 30¢ for every electronic bill it handles. It figures E-bills will someday be as common

wherever it forages, thanks to a \$13.5 billion cash hoard and the power of its Windows monopoly.

Microsoft's critics say those assets give it an unfair advantage. The software giant prices products aggressively when faced with tough competition—bundling programs such as the Web browser for free with other products or throwing in freebie software to close a big sale. At the same time, it is tight

as E-mail—only much more profitable.

There's no assurance that Microsoft will thrive in all of these new markets. Look at Sidewalk, its 18-month-old effort to create a network of hometown arts-and-entertainment guides on the Web. Sidewalk has undergone fits and starts.

But what makes Microsoft so tough to beat is that it almost never gives up. Sidewalk will be reborn in November as a national consumer-shopping guide focusing initially on entertainment, consumer electronics computing, and appliances—and connecting consumers with retail or online shops. Since the start of the year, Microsoft has sold an enviable \$26 million in ads for the revamped site to more than 6,000 advertisers. And Sidewalk will be tied to Microsoft's new portal site msn.com.

Microsoft's tenacity—an ceaseless quest for new markets—is bad news for competitors. The company is

force to be reckoned with

NEW WORLDS TO CONQUER

ENTERTAINMENT

CONSOLES Sega will launch its new Dreamcast game console in Japan in November. One of the two optional operating systems is Microsoft's Windows CE—marking Microsoft's first entry into the \$5 billion videogame-software sector.

PC PHONES Microsoft is about to ship its \$199 Microsoft Cordless Phone, a Microsoft-branded hand-

set connected wirelessly to a PC that manages messaging, Caller ID, and an electronic address book.

EMBEDDED SYSTEMS

These devices aren't glamorous, but there are a million of them. Microsoft's Windows CE operating system is just starting to ship inside such diverse machines as a milk-purity monitor, a check scanner, and a fast-

food ordering kiosk. The market for such software is expected to grow to \$2.3 billion in 2001.

ELECTRONIC BILLS

Before yearend, Microsoft's TransPoint joint venture with FDC and Citibank will begin offering online billing and bill-payment services nationwide. TransPoint will charge 30¢ per bill—a potentially lucrative business consid-

ering 15 billion consumer bills are mailed annually.

ONLINE BUYING GUIDE

Microsoft is relaunching its Sidewalk.com sites, which were arts-and-entertainment guides for nine major cities, as a nationwide consumer guide with tips on buying everything from cars to catering services. Microsoft has already signed up 6,000 advertisers.

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pentium II



FIELDS OF GREEN More than 100 developers have used Microsoft's \$495 kit, making everything from bar-code scanners to milk-quality testers

IDEXX LABORATORIES ENGINEER MAILLET

ening the rules for some corporate customers in ways that boost their software bills. And Microsoft isn't afraid to do things that look like bullying—its unsuccessful attempt last spring to co-opt 3Com Corp.'s popular Palm name for Windows-based handheld PCs is one example.

That's the picture Justice is trying to paint. Rather than trying to prove only that Microsoft illegally tied its Web browser to Windows to head off competition, government lawyers are now hoping to show a broad pattern of anticompetitive behavior. They say Microsoft is unfairly using its clout to defend its desktop monopoly and to gain ground in new markets.

COPYCATS? Just ask the folks at the Palm division of 3Com, maker of the Palm electronic organizer, a runaway hit. Microsoft decided to call handheld devices based on its Windows CE operating system Palm PCs. 3Com sued, claiming it owned the Palm name. "In the middle of this an-

titrust investigation, Microsoft was trying to steal our brand," says Donna Dubinsky, the former head of 3Com's Palm Div. who now runs startup JD Technology Inc. Even after Microsoft backed off, it offered buyers of its Palm-size PCs a free copy of Windows 98.

To its critics, Microsoft's tactics in emerging markets look a lot like the techniques it used so successfully to

squelch competition in the PC software industry. Some of Microsoft's new competitors complain that it makes misleading claims and preannounces products in order to freeze buying decision or that it leverages its strength in PC software to boost new products.

In electronic billing, Microsoft's press releases boast that it will offer the world's "first end-to-end bill-presentment service" in spite of the fact that CheckFree Corp. in Atlanta has been offering such services for nearly a year. (Microsoft's explanation is that CheckFree still issues some paper checks, so it's not totally electronic.) "This harms our business," says CheckFree CEO Peter Kight. "We're out ahead, but they try to get people to stop and wait for them."

It's a similar situation in the market for software used in industrial devices, according to Wind River Systems Inc., Alameda, Calif., the leader in that category. A year and a half ago, Microsoft promised developers it would produce a version of its Windows CE software capable of running factory-automation sensors. That software is still a year or so away, though Microsoft maintains it didn't formally announce the product until late April. And when it lacks experience in a market, Microsoft can always throw money at a problem—the way it is spending \$200,000 for the biggest booth at the upcoming Embedded Systems West trade show.

Microsoft's clout in PCs is one of its most strategic weapons. Take electronic commerce software. In mid-October, Microsoft began testing a service for selling its software programs off of its Microsoft.com site. Customers who click on an "Order Now" button are referred to a handful of online retailers. It's tremendously valuable for merchants,

be directly linked to the Microsoft site, and they pay a fee for it. But, perhaps more vital for Microsoft, participating retailers are required to use Microsoft's Commerce Server software. That makes the service work more smoothly, Microsoft says, but it also discourages retailers from buying E-commerce software from rivals.

Microsoft has eased back only a fraction under pressure from Justice and a Senate committee. While Microsoft dropped some restrictions on PC makers and Net service providers' freedom to promote alternative browsers, the damage had already been

THE MICROSOFT MONEY MACHINE

► Microsoft has issued 807 million stock options to employees since 1990—worth \$80 billion if they were exercised today.

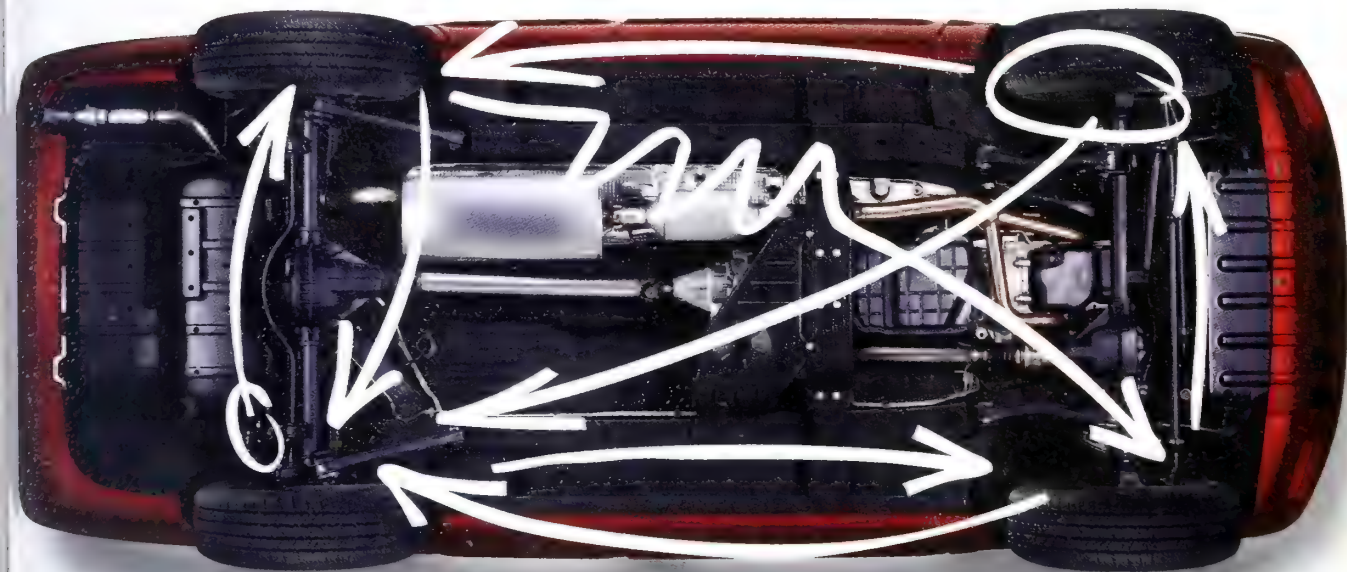
► Analysts estimate several thousand of Microsoft's 28,000 employees are stock-option millionaires. Even relatively low-level managers can tuck away a small fortune.

► The option plan has made some veteran executives fabulously wealthy, including Michel Lacombe, president, Microsoft Europe, \$152 million; Paul Maritz, group vice-president, \$176 million; Nathan Myhrvold, chief technology officer, \$179 million; Jeffrey Raikes, group vice-president, \$237 million.

► But the biggest winner is Bill Gates, whose 20.8% stake in Microsoft is worth a staggering \$50 billion.

DATA: MICROSOFT ANNUAL REPORT AND PROXY

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done to rival Netscape Communications Corp. According to International Data, Netscape's browser market share dropped from 50% to 43% during the first half of this year.

Microsoft's monopoly profits allow it to give away a lot of software, such as browsers, where it needs to gain ground. For example, the company will soon throw a basic data analysis program—for which Oracle charges \$4,995 for a rival product—into its SQL Server database. "They create a platform that has the potential to suck in all of their competitors," says Vern Keenan, president of consulting firm Keenan Vision Inc.

Microsoft's pricing strategies can cut against customers, too. Gartner Group Inc., which consults to corporations, says Microsoft hooks customers with low bids during an initial sale but makes up for it later with policy shifts that raise overall costs—a view Microsoft vehemently disputes. In a recent memo to clients, Gartner Research Director Mary Welch warned that companies "using Microsoft software should expect to pay 50% more per year through 2002 as a result of changes to terms and conditions."

And Microsoft is making it even easier to hook customers. It has started offering so-called Enterprise licensing agreements where, for one price per desktop, they get unlimited use of Windows NT, Office, and BackOffice, as well as upgrades. That unfairly ties the licensing of the operating system to other Microsoft products, contends Ken Wasch, president of the Software Publishers Assn., and "has an adverse impact on anyone competing with the Microsoft suite of products."

ATTENTION. Gartner takes "an extreme view" of Microsoft's licensing policies, says Deborah Willingham, vice-president of Microsoft's Enterprise Customer Unit. She says the changes are part of an effort to simplify complex licensing agreements and that Microsoft is willing to negotiate with any customer who fears its costs will go up. And the one-price-for-all enterprise agreements are not uncommon in the software industry.

Even some of its harshest critics acknowledge that most of what Microsoft does is legal. And many of the software maker's recent successes came as a result of a relentless pursuit of deals and part-

ners rather than competitive misdeeds.

Look at how the company is rallying support for its SQL 7 database—a vital program that stores data and manages transactions for corporations that is due out in November. Oracle Corp. and IBM are way out ahead in that \$6.6 billion market category, but Microsoft has persuaded a half-dozen major corporations to take a huge risk and run vital parts of their businesses on a test version of the software—and help Microsoft demonstrate on launch day that the product is safe and sound.

To win participants over, Microsoft

ward. Microsoft intends to defend itself in court in part by showing that rivals such as Netscape got into trouble because of their own missteps.

Even so, government trustbusters say they've gathered enough damaging evidence to prove that Microsoft has unfairly used its power. That's why many industry observers think Microsoft would be wise to notch back its hyperaggression. James Cannavino, an ex-IBM exec who is now CEO of CyberSafe Corp. in Issaquah, Wash., thinks Microsoft needs to grow up: "When you're a little company fighting bigger fish, it's O.K. to

write exclusive contracts. But when you have market power and exclude competitors with contracts, that just won't fly."

Microsoft might do well to adopt a strict antitrust-compliance program that could help it steer clear of trouble with the law. Intel's program for instance, requires nev-



KA-CHING!

After last year's \$50 million in Barney doll sales a slew of new gizmos are ready

HARDWARE HONCHO THOMPSON AND FRIENDS

offered an unprecedented package of assurances and around-the-clock help. For Penzoil Co., Microsoft even created an exact replica of a key corporate database in Redmond, Wash., and tested it repeatedly. The result: Penzoil switched over to SQL Server in just two days.

It's Microsoft's flat-out attention to the needs of partners that distinguishes it from some of its rivals. Atlanta (Ga.)-based Radiant Systems Inc., for instance, evaluated Microsoft's Windows and Sun Microsystems's Java operating system for its fast-food ordering kiosks and multimedia gas pump-payment systems. It went with Windows because Microsoft's people showed an intense interest in Radiant's plan. "They get down into the guts of a business until they understand it and can respond to needs—and they are very aggressive about it," says Jimmy Fortuna, Radiant's product-line director for platforms.

Microsoft's rivals aren't always as willing—or able—to bend over back-

employee training, quarterly reviews by top execs, and a once-a-year refresher course. Lawyers review every major transaction. If somebody doesn't play by the rules, they're sent back for remedial training.

You're not likely to find Microsoft employees keen about that. Although lawyers review its business activities for violations, most employees don't get antitrust training. "We don't want to discourage our people from being imaginative and zealous in how they do business," says William H. Neukom, vice president for legal affairs. But unless Microsoft finds a way to avoid settling off alarms at every turn, its long war with Justice on its back may start to feel like an endless journey. Even if it wins the current case, it will still have the one after that, and the one after that, to worry about.

By Steve Hamm in Redmond, Wash., with Amy Cortese in New York and Peter Burrows in San Mateo, Calif.

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THE INTERNET

THE SKINNY ON NICHE PORTALS

Specialized sites like ESPN's pile on services and links

Just when you thought you knew all there was to know about portals—those whopper World Wide Web sites that offer a dizzying array of services and information—a new generation is emerging. Called specialty portals, these sites are single-subject hangouts—like the No. 1 sports site, ESPN—that are now racing to adopt the features of their broader counterparts, like E-mail, search, and E-commerce. “I don’t think there’s anyone out there who now thinks a narrow play can carry the day,” says Geoff Reiss, senior vice-president for programming and production at ESPN’s Internet Group.

Broader is definitely better on the Web. In short order, megaportals such as Yahoo! and Excite have expanded their turf to include areas the single-subject sites once claimed—finance, health, sports, women’s issues, and the like. That has attracted a boatload of visitors—and advertising dollars. Yahoo!, for example, draws over 40 million different users a month, while iVillage.com, the most popular women’s site, brought in just 3 million in September, according to Media Metrix Inc. What’s more, this year megaportals will grab about 67% of North American ad dollars spent on the Internet, or \$870 million, estimates Forrester Research Inc.

FIGHTING BACK. Now specialty sites, such as E*Trade and ESPN, are fighting back. Book-and-CD goliath Amazon.com Inc. in August snapped up PlanetAll, a service that allows people to stay in touch by organizing address books and their calendars. Women.com Networks and iVillage.com have added E-mail. And ESPN plans by the end of the year to offer search capability. “If you think there are going to be three big [portal] brands and everyone goes there, it’s not so. There will be a lot of specialized sites,” says Oracle Corp. CEO Lawrence J. Ellison.

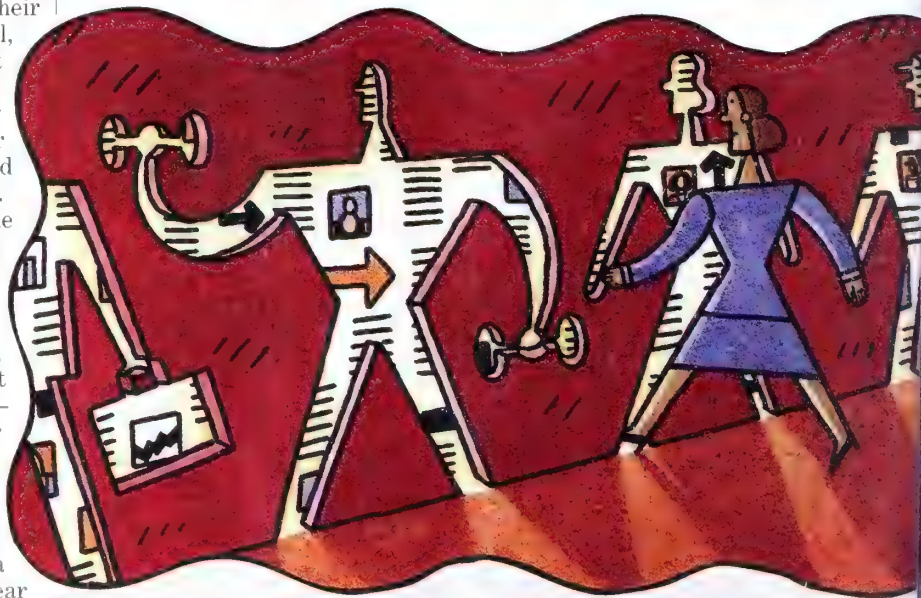
E*Trade Group Inc. saw the shift

coming 18 months ago and immediately began planning its strategy. E*Trade’s goal: to become the hub for all things financial on the Web, not just a low-cost trading site. Late this summer, E*Trade launched a totally revamped site. Gone was the front door that gave only members access to E*Trade’s services and data. Now the

site provides information, such as financial news reports, company releases, and stock quotes—for free—and has added chat, insurance, and mortgage services. Since the beginning of September, traffic to the Web site has more than doubled, says Christos M. Cotsakos, E*Trade’s chief executive officer.

E*Trade’s approach is only one of many being adopted by the crop of finely focused portals. CNET Inc., a popular tech news service, is making a more radical change, morphing into a be-all of tech information (page 68). Many health sites already have links to government and nonprofit sites, but they’re adding online shops for health insurance or prescription refills.

The end goal is to pump up revenue. By adding free services and more content, these sites could attract more visitors—hence sorely needed advertising dollars. After ESPN reconfigured its site



Bulking Up

CATEGORY/PLAYERS	STATUS
SPORTS ESPN SPORTSLINE	Aimed at men 18–34, these sports sites have been around for years but are now adding more content from elsewhere on the Web. ESPN also was redesigned in September, pumping up the sports products it sells and making it an umbrella portal linked to other sites, including NFL.com. SportsLine is piling on info from the Minn. Co. on 500 different topics and offering free E-mail.
HEALTH INTELIHEALTH DR.KOOP	These sites offer a wide variety of medical data and health tips. Players are now adding services like wellness assessment tools, online pharmacies, and health insurance.
WOMEN iVILLAGE.COM WOMEN.COM	Finally coming into their own now that women account for 43% of people online, these sites are adding services such as health and financial advice. Women.com has content from such partners as Bloomberg financial service, while iVillage offers investment info from Intuit. The sites boast free E-mail and products like baby toys.

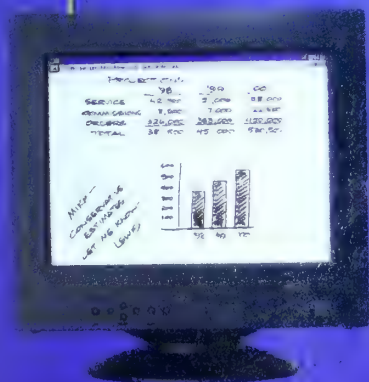
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in September to serve as an umbrella portal linked to other sites, including NFL.com, it had the best monthly growth spurt all year: about 1.1 million average daily visits in September, up from 628,000 a year ago. And, while ESPN won't disclose revenue, it says it had its best ad sales ever in that month.

And there could be additional revenue streams. The megaportals already have shown that drawing more visitors translates into distribution deals in which a portal collects a fee for direct-

ing consumers to a partner's Web site. Last month, for example, portals AltaVista, Infoseek, Lycos, and Snap! ponied up over \$60 million to be featured on Microsoft Corp.'s newly launched MSN.com portal site.

Now vertical portal SportsLine USA Inc. is doing the same. It has inked a dozen marketing deals with companies, including Mining Co., which provides site reviews and discussion groups to SportsLine. "Content is king, but distribution is King Kong," says Andrew S.

Sturmer, SportsLine's vice-president for business development.

The skinny-mini portals expect that new users, once they learn about the specialized services, will prefer them over megaportals. "Portals are a bit of a hodgepodge," says Candice Carpenter, CEO of iVillage.com. Inc. "Our users have said, 'Give us a place that will serve us so we don't have to go some where else.'" And so portal combat rages on.

By Heather Green in New York

THE INTERNET

CNET: A HOME FOR TECHIES AND NEWBIES ALIKE?

Once a gearhead hangout, the site now has to widen its appeal

At CNET Inc., this summer should have been a season for high fives and strawberry smoothies. The six-year-Internet startup that focuses on tech news and services had pocketed \$32 million from NBC in June for stakes in CNET and its portal, Snap!, a costly online service that had tied up scarce company resources for more than a year. CNET's stock, after languishing since the beginning of the year, was finally headed skyward. More important, the San Francisco company had joined the rarefied ranks of profitable Net ventures.

But instead of rejoicing, CNET has been regrouping. Finally freed from the distractions of Snap!, company executives have been giving CNET itself the once-over. It's not that CNET's network of Web sites and cable television programs devoted to technology and computing was in trouble. But CEO Halsey M. Minor figured they could be if something dramatic wasn't done to trump the army of Web competitors suddenly swarming into its space.

LITTLE CHALLENGE. In CNET's earliest days, few rivals seriously challenged it for precious advertising dollars or for the cybernauts who surfed the Web for technology news and information. But now, CNET must do battle with the likes of portal Yahoo!, tech publisher Ziff-Davis, and even Dell Computer—all of which have

beefed up their online tech offerings. "The days of CNET just throwing anything up on the Web and people going to it because there is nothing else are over," says Julie Bauer, president and CEO of Saatchi & Saatchi San Francisco, CNET's ad agency. "CNET has to be smarter and brighter in how it positions itself to be successful."

That's why the company is eyeball-

deep in CNET 2000—a top-to-bottom redo of its eight Web properties. The goal: to make CNET's sites appeal a much to tech novices as they do to gearheads. Indeed, the new CNET, which will be unveiled in stages over the next three months, will look more like Snap! for all types of tech seekers. Want to build a corporate Web site? Come to CNET. Interested in sending family snapshots over the Net? CNET will tell you how. In search of a new laptop? CNET

recently launched shopping channel can help. CNET will feature a re-fashioned, easy-to-use front door complete with simple-to-navigate area headings, such as hardware and the Internet. And, on Oct. 1, CNET began offering free E-mail. **ALL THE RAGE.** This one-subject-with-loads-of-goodies approach is now all the rage on the Web as companies try to remake themselves into so-called specialty portals. The notion is that by offering some of the same features and services as the megaportals, single focus sites can grab more traffic and advertising dollars.

To do this, Minor is even willing to ditch CNET's obsession with original content, widely considered the company's greatest strength. M

PREEMPTIVE STRIKE

CEO Minor hopes his one-subject-with-loads-of-goodies strategy will fend off megaportals and boost ad dollars

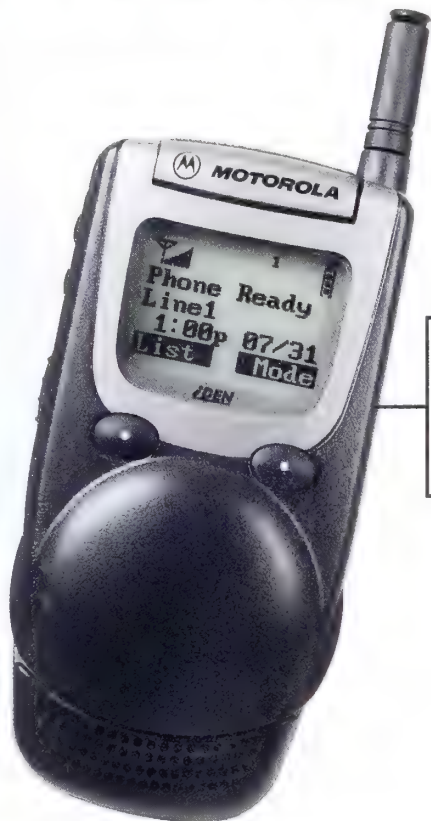
nor says his Web baby will for the first time offer sources of news and information beyond its own. Like Snap! and Yahoo!, CNET already is trolling the Internet for other sites' jewels—such as computer product reviews—in an effort to build a service so deep and wide that it will feed virtually every one of its users' tech habits.

Think of CNET as the *Tool Time* show for the Web—a cozy hub for all tech



PORTALS A CASE STUDY

SPEAKERPHONE TO GO



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needs. And when CNET can't fill an order, it will guide users to another place on the Web that can. "The one great use of the Web that we've been missing is being utterly, singularly complete about one topic," says Minor. "On the Web, you know what people want and you can respond."

TEPID REACTION. CNET's response has been to unleash its top dogs over the last 10 weeks to survey employees and advertisers, discuss site redesigns, and meld CNET's sites into a seamless service. They also have compiled a 13-page list of more than 200 new product ideas, including better technologies for measuring the effectiveness of ads and a stand-alone database of computer-product reviews that can be continually updated. Even News.com, CNET's popular tech-news service, will launch a more comprehensive version of itself in late October that will include coverage of technology as it relates to business in general. "We have to change because the market is changing," says Tom Melcher, senior vice-president for strategy and development.

To do that, Minor has had to convince his roughly 500 employees that it's O.K. to be merely knowledgeable about cer-

tain topics rather than authoritative sources. That's no easy feat considering that most traditional editorial operations frown on delivering someone else's handiwork—much less actually pulling it together for readers. So on Sept. 9, when staffers of the flagship CNET.com site were first briefed on Minor's vision, the initial reaction was tepid at best. "There was a notion that we could do all this amazing work and it wasn't considered valuable," recalls Alice M. Hill, editor of CNET.com.

CNET's discouraged workers came around when they listened to a reworked presentation that acknowledged the value of their editorial contributions and highlighted the overall benefit to the company should CNET change its ways. "If someone comes to our site, and they want to build a Web site and we don't do that, we're not useful for that person," says Hill. "Isn't it better to offer something to that person rather than nothing?"

CNET may have convinced its employees that it's on the right track. But analysts are still questioning the com-

pany's business prospects. CNET's online unit accounted for \$11.2 million in its most recent quarter, up 69% over a year ago. Virtually all of that dough came from straight advertising on the sites.

The expanded CNET and its spiffy new look is all well and good, analysts

NEW LOOK FOR CNET

THE PLAN Later this year, the site will recast itself as a "megaportal" focused on technology—and not for techno-works, but for the masses with news, info on products, search and E-mail.

THE REDESIGN Will take on a pop-like front door design, featuring lists of categories such as hardware, software and the Net. The CNET brand, will be displayed at the top of each page.

say. But if the company wants to compete with the Web's elite portals, it will have to help sell products. "Content-specific sites without this other piece of the puzzle will have a very difficult time," says Mary Meeker, an Internet analyst at Morgan Stanley Dean Witter. "The real question for CNET comes back to how it will get people to buy products." Meeker adds



hat CNET probably delivers more goods—namely software—to its customers through its Download.com site than almost any other Web player. But CNET doesn't get a penny from that.

Minor says CNET has no intention of selling products directly. But he says the company in October began collecting fees for every potential buyer it sends to one of its advertisers through its Shop-

ne will be promoted through TV, billboard, and online ads.

ENT Plans to compile content from most any tech source, including Giff-Davis and CMP. CNET also offer a broader range of tech-relations, like how to build a Web page photos on the Web.

UE Aims to grab more non-tech users (77% of ads on the service

er.com site, which was launched in June. On Oct. 19, the company is expected to announce these so-called per-lead deals with 54 merchants, including Egghead.com and Dell.

Although executives won't say exactly how much any one company is paying, these deals could add up to a wad of cash since CNET says it sends on average some 40,000 potential customers a

day to its commerce partners. Minor expects per-lead revenues to account for at least 50% of the company's total revenues by 2000—pegged by analysts at about \$111 million. "We will be a huge source of leads to people who want to buy and to sell stuff," says Minor, adding that CNET will soon expand this service into new categories such as consumer electronics.

now are placed by technology companies) by offering new types of ads and better analysis on the effectiveness of online ads. CNET hopes to collect additional fees each time it sends a potential buyer to an advertiser.

CNET UNIVERSITY Early next year, all employees will go through two-week training programs to learn CNET's new approach of categorizing and compiling outside sources of tech information.

Advertisers must agree since few blinked when CNET told them that they would have to start paying for leads in addition to their ad buys. That may be because 46% of Netizens use the Web to research products they plan to buy, according to Forrester Research Inc. Says Craig A. Winn, CEO of Charlottesville (Va.)-based computer reseller Value America, a CNET advertiser: "CNET

draws knowledgeable people in and generates leads to informed buyers."

CNET also is hoping to attract more non-tech marketers. Although technology companies currently make up 77% of CNET's advertisers, Gregory J. Osberg, president of sales and marketing, says the company has set its sights on five consumer categories of advertisers: consumer electronics, telecom, finance, automotive, and travel. He'll try to woo them with CNET's new advertising services that go beyond traditional banner ads, which are much like billboards on a highway. There will be sponsorships of product sites and seasonal sections such as holiday shopping guides.

Will this ambitious agenda work? CNET had better hope so. The company, while valued by investors at 9.7 times projected 1998 revenue, still isn't in the same league with such highfliers as Yahoo!, which is trading at 54 times 1998 revenue. To get there, CNET will have to work fast to establish its brand as the Web's be-all on tech. But with so much competition—and room for just one or two successful players in each subject category, CNET's future is far from assured. Then again, if Minor's bet is on target, his company can start whipping up those strawberry smoothies.

By Linda Himelstein in San Francisco

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COMMENTARY

By Ronald Grover

PRO FOOTBALL IN L.A.? DON'T BET THE BENTLEY

Ever since 1995, when Al Davis packed up his Raiders and moved them back to Oakland, Los Angeles has been getting kicked aside by the National Football League. Since then, L.A. fans watched as expansion teams began to play in Jacksonville and Charlotte, the Browns went to Baltimore and the Oilers to Tennessee, and Cleveland got back a franchise. For Angelenos, pro football is a TV set.

Now, the city's best shot for a team in a long time is fast approaching. On Oct. 27, three potential owner groups, including two from Los Angeles, will make presentations at the NFL owners meeting in Kansas City. The L.A. contingents—one of them led by former superagent Michael S. Ovitz—will try to convince the pigskin pooh-bahs that the city should be awarded the NFL's 32nd franchise, most likely at its annual meeting in March. Play would begin in 2002.

With a TV market of more than 3 million homes, the

with everyone behind it, L.A. isn't going to get a team."

The front-runner is a star-studded group headed by Ovitz, the onetime Hollywood talent agent and former Walt Disney Co. president. He has lined up Tom Cruise, Magic Johnson, Shaquille O'Neal, Northwest Airlines Chairman Gary Wilson, and investment banker Ted Forstmann, among others. Team Ovitz has excit-

ting to do. Neither has shown it has its financing in place, including the \$480 million or more the NFL will likely demand as a franchise fee. Ovitz' site on a former landfill in industrial Carson, 15 miles southwest of Los Angeles, has to be cleaned up, and no one is sure fans will travel there. To overcome the Coliseum's

Raiders-era image of beer fights and biker gangs, Roski will bring to Kansas City a videotape of fresh-faced kids cheering at the Oct. 3 University of Southern California-Arizona State game at the Coliseum.

But while they may love college football, do Angelenos really want the pros? In a *Los Angeles Times* poll in January, 59% said a team wasn't important to them at all. One big problem may be demographics. The composition of the city has changed in the past 20 years and is now 40.1% Hispanic and 12.5% Asian.

While many Hispanics and Asians tend to avidly support baseball, for example, as groups they seem less enthralled by football.

EAGER FANS. Meanwhile, Houston's bidders will arrive in Kansas City with a guaranteed income stream from stadium sales taxes and polls showing 58% of city residents would buy tickets. "I don't worry about L.A. They have enough to worry about themselves," says Steve Patterson, head of the Houston group.

Patterson is right. Mike Ovitz and Top Gun Cruise and Shaq may put on all the glitz they can, but in the end, the NFL will want them to show it the money. Until Los Angeles can do that, a football club will remain a very different kind of dream team.

Grover is Los Angeles bureau chief.

Team Ovitz includes Magic, Shaq, and Tom Cruise. But glitz may not be enough

NFL would love to add Los Angeles to its Neilsens. But winning a club could be harder than stopping Brett Favre at the one-yard line. For starters, the two L.A. groups are far behind one from Houston, which expects to bring signed documents for a lease as well as for more than \$200 million in public financing to build a \$311 million stadium. And the Los Angeles split between two competing camps isn't likely to play well with the NFL. Sputters sports agent Leigh Steinberg, who led an unsuccessful campaign in 1995 to keep the Rams from leaving for St. Louis: "Until one group emerges

ed NFL owners with plans for a 76,000-seat stadium modeled after a 19th-century California mission.

Under the competing bid, the 66-year-old Los Angeles Coliseum would be redesigned as the centerpiece of an entertainment zone. That plan is being promoted by real estate developer Edward Roski Jr., who brokered a \$350 million deal for the new Staples Center for the Los Angeles Kings hockey team, of which he is a majority owner. The group includes reclusive Denver billionaire Phil Anschutz, another Kings owner, and former Ticketmaster CEO Fred Rosen.

Both rivals still have a lot of hus-



PERILS OF THE HEDGE HIGHWIRE

Locking in exchange rates isn't always a great idea

As a company that gets more than half of its sales and profits in foreign currencies, Minnesota Mining & Manufacturing Co. is exquisitely sensitive to fluctuations in exchange rates. When the dollar rises, profits fall. Yet 3M doesn't use hedges to protect against currency fluctuations. In August, the maker of Post-its and Scotch Tape announced that the dollar's rise had cost the company \$330 million in profits and \$1.8 billion in revenue over the past three years. The no-hedging policy has analysts and investors in an uproar. "They have lost all credibility with Wall Street," says Jack L. Kelly of Goldman, Sachs & Co.

But is 3M really so dumb? Not according to academics, consultants, and a slew of other big companies that choose to hedge very little or not at all. Companies ranging from Kodak to Deere to Exxon argue that currency fluctuations help profits as often as they hurt them—and that hedging simply doesn't pay.

NOT CHEAP. The reason: Big companies can generally ride out negative currency moves without having to cut back on, say, capital spending or research and development. Moreover, hedging isn't cheap. And though the costs might be worth overlooking if hedging generally worked, studies show that hedges often fail at their main aim: cutting volatility of sales, cash flows, and earnings. "In many cases, the best solution is simply not to hedge," says Tom Copeland, a corporate finance consultant at Cambridge (Mass.)-based Monitor Co.

Currency hedging has emerged as a front-and-center issue because of the



With currency markets going wild, deciding whether or not to hedge is crucial

recent surge in exchange-rate volatility. Asian currencies and the Russian ruble have crashed over the past year. And after soaring 70% against the yen in three years, the dollar slid 15% in a mere day and a half early this month. It's little surprise, then, that many companies hedge. The University of Pennsylvania's Wharton School and Canadian Imperial Bank of Commerce found in a

recent survey of 400 U.S. companies—many among Corporate America's largest—that one-third do some kind of foreign-currency hedging.

The standard argument for hedges is increased stability. "We're trying to reduce volatility in earnings and cash flows," says Lori A. Walker, director of global financial risk management at controls supplier Honeywell Inc., which gets 40% of its business outside the U.S. When effective, the decrease in volatility means that companies can smooth out cash flow, making it easier to plan spending. Lower volatility also reassures lenders and investors, and makes forecasting year-ahead results for Wall Street easier.

Drug giant Merck & Co., for instance, hedges some of its foreign cash flows using one- to five-year options to sell the currencies for dollars at fixed rates. Merck argues that it can protect against adverse currency moves by exercising its options, or enjoy favorable moves by not exercising them. Either way, the company aims to guarantee that cash flow from foreign sales remains stable so that it can sustain research spending in years when a strong dollar trims foreign earnings. "Volatility is here to stay," says Judy C. Lewent, Merck's highly regarded chief financial officer. "We pay money for insurance to dampen volatility from untoward events."

But many well-established companies see no need to pay for protection against currency risk. Copeland points out that many choose to cover the risk out of their own deep pockets, similar to the way they self-insure against fire and floods. Take 3M. In spite of currency-related losses over the past three years, the company has steadily increased its R&D budget, from \$883 million in 1995 to \$1 billion this year. "If you look at the cost of hedging over the entire cycle, the hit to your cash flow is incredible for buying that insurance," says Janet L. Yeomans, 3M vice-president and treasurer. "We would prefer to find operating solutions to those problems."

Indeed, hedging itself eats into profits. A simple forward contract that locks in an exchange rate costs half percentage point per year of the revenue being hedged. Other technique



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such as options are more costly. And they don't buy much. A 1996 study that Copeland co-wrote while at McKinsey & Co. concluded that most hedging actually doesn't significantly cut volatility. Using 10 years of earnings statements from 198 large U.S. companies, the study found that only one could have reduced its annual volatility by more than 20% through hedging.

The reason is that fluctuations in the underlying business can spoil the hedge's effectiveness. Take the case of a U.S. company exporting to Japan. Assuming local sales in yen remained stable, a stronger yen would be expected to increase the outfit's revenues when translated into dollars, while a weak yen would normally lead to lower revenues in dollars. In either case, a hedge would gain in value if the yen fell, and vice versa. The goal: Sharp ups and downs in earnings would smooth out.

But if the company's local sales happen to weaken at the same time—say, because of a slowdown in Japan—then hedging against a stronger yen can actually exacerbate volatility. Not only will revenues from Japan fall in terms of U.S. dollars, but the hedge will lose money as well. In fact, that's probably

happening right now to some companies that hedge against the yen.

Indeed, it can be so hard to get hedges right that many companies have decided they're not worth the trouble. George M. Fisher abandoned Eastman Kodak Co.'s aggressive hedging strategy shortly after becoming CEO in 1993. He concluded that hedging wasn't necessary since the ups and downs of currencies would even out in the long run.

At present, that's an unpopular position. On Oct. 13, Kodak announced that currency translations would cost it some \$384 million in revenue and 30¢ a share in profit for the year. In its aversion to hedging, says analyst Michael W. Ellmann of brokerage Schroder & Co., "Kodak is so conservative as to be aggressive." But Harry Kavetas, Kodak's CFO, says the tide is turning: The newly lower dollar should add a penny to fourth-quarter earnings per share.

For companies with a strong belief in hedging, the sustained rise in the dollar over the past several years proved a serious test. Coca-Cola executives have bragged to investors that by using options, they can limit the negative impact of unfavorable currency swings on earnings to 3% annually over

the long term. That hasn't been the case, however, in 1998. The company warned last December that currency moves would knock 6% off expected 1998 profits and has since boosted the estimate to 9% to 10%.

PROFIT HIT. Two-year hedges taken during 1995 on the Japanese yen and German mark did help keep Coke's profits up temporarily. But when they expired last year amidst a significantly stronger dollar, the transition as foreign earnings were translated into dollars was far more abrupt. That's hardly consistent with the idea of smoothing earnings. Worse, now the hedge is hurting profits. Well before the yen's recent rise, Coke set its dollar-yen rate for the year.

Surprisingly, many companies that hedge don't seem to have thought much about how they perform. The Wharton-CIBC study found that 44% of the companies that hedge have no yardstick to measure if their program is succeeding.

Just as problematic, many seem to be using hedges to speculate on currency movements as well as to guard against them. In the Wharton-CIBC survey, some 26% of the companies that hedge say they sometimes "actively take positions in currencies based on their market



The strength of any element is not in its might but

ews, and an additional 6% do so frequently. That's little more than a eulogism for speculation. "I'm amazed how many firms respond positively," says Gordon M. Bodnar, an assistant professor of finance at the University of Pennsylvania's Wharton School and co-author of the study.

NATURAL. Given the mixed record of much hedging, Bodnar and others believe that any companies do so principally to simplify corporate budgeting or please Wall Street. Even if the hedging doesn't reduce the volatility of earnings, it might improve the ability to forecast them over the short term. "Predictability and consistency of earnings play a big part in valuations,"

says William Pecoriello of Sanford C. Bernstein & Co., who follows Coke.

In fact, some companies that hedge knowledge that short-term planning is what dictates hedging policy. Why hedge when the ups and downs of the dollar

eventually net out? "We've talked about that," says Terry Gray, Honeywell's director of global capital structure. "But we've never had a CFO or chairman that had a 20-year tenure."

FOUR COMPANIES, FOUR STRATEGIES

Does hedging protect against currency volatility? The record is mixed.

COCA-COLA

A big hedger, Coke says that over the long term it can limit profit damage from exchange rates to 3% annually. But this year, analysts expect currency mismatches to erase about 10% of earnings.

EASTMAN KODAK

CEO George Fisher ended aggressive hedging in late 1993, concluding that the benefits didn't justify the costs. Now, Kodak hedges only a few specific contracts, not its overall receipts and payments.

Perhaps the best solution to fluctuating currencies is to create "natural hedges," in which revenues and costs are in the same currencies. Companies with natural hedges still have to translate foreign sales, profits, and assets

IBM

By locating plants in many countries where it does business so its costs are in the same currency as its revenues, IBM reduces the impact of currency swings without hedging.

3M

Arguing that gains and losses will even out over time, 3M does not hedge foreign-exchange exposure. Over the past three years, however, that has cost the company \$330 million in profit.

into dollars at unfavorable rates for accounting purposes. But by using locally earned revenues to fund the production of local goods, for example, they reduce the hit to earnings that comes from exporting products from a strong-currency country to one with a weak currency.

IBM, for instance, locates facilities in countries where it does lots of business. Coca-Cola, rather than repatriating profits in devalued foreign currencies, reinvests in local bottling operations. Even Merck's Lewent says her company prefers natural hedges where possible. Derivatives such as currency options, she says, are a fallback because they need foreign revenues to cover U.S. costs, especially R&D. 3M executives may be more extreme than most in their distaste for hedging, but they're hardly alone.

By Peter Coy in New York, with De'Ann Weimer in Chicago and Amy Barrett in Philadelphia

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A 'DEAL JUNKIE' GETS A NEW FIX

Now, cable guy Jeff Marcus is making big acquisitions as radio giant Chancellor Communications' boss

Jeffrey A. Marcus is nothing if not enterprising. To help pay his way through college, he resorted to driving a garbage truck, then bootstrapped his way into the cable-TV industry by selling subscriptions door-to-door. Thirty years of frenzied dealmaking later, Marcus Cable Co. was so large that Microsoft Corp. co-founder and billionaire Paul G. Allen had to pay \$2.8 billion last May to get him to part with it. Of that, Marcus cleared an estimated \$115 million.

But Marcus hasn't stopped there. Today, he is installed as CEO of Chancellor Media Corp., which is partially owned by Dallas-based leveraged buyout firm Hicks, Muse, Tate & Furst Inc. In his four short months on the job, Marcus, 52, has already cut a dizzying \$8 billion worth of deals, some of them controversial. The biggest, a \$4.1 billion deal to acquire Capstar Broadcasting Corp., should push Chancellor ahead of CBS as the country's largest radio company, with \$2.5 billion in revenues, when the deal closes next year. "It would be nice to think Jeff would slow down now, but he can't," says Wes Hart, director of corporate sales for Marcus Cable. "Jeff's a deal junkie."

ROUGH SLEDDING? Can Marcus pull together Chancellor's sprawling empire—the company also owns television stations and a billboard display unit—and make it run smoothly? The challenges are formidable. For one thing, all the recent dealmaking has left Chancellor deeply in debt—six times 1999 cash flow estimates, vs. an average of four times for its peer group. At the same time, the specter of an economic slowdown will make Marcus' new job especially difficult. Although ad revenues have been rising smartly, in a slowdown, cor-



porate ad budgets are usually the first to get the ax.

In the cable industry, at least, Marcus has an impressive track record. He has been eating and sleeping cable TV since he was 19. Thanks to his father's career as a furniture salesman, Marcus seems to have salesmanship in his blood. To make ends meet in college, Marcus switched from hauling trash to hawking cable subscriptions when he noticed his college roommate at the University of California at Berkeley was putting in fewer hours and making more money. "It didn't take long to figure out who had the better job," Marcus recalls.

MARKETING MIGHT. Marcus started small in the cable brokerage business, though his company's grandiose name, Communications Equity Associates, hinted at bigger things to come. As Marcus honed his dealmaking skills, he started snapping up small, family-run cable companies. He would then fix them up—by adding channels, for example—and resell them to large cable companies at a 20% markup. His "greatest strength was his attention to marketing details," recall former CEA associate Gene Gawthrop.

At the same time, Marcus was crisscrossing the country with his brokerage's biggest client, TCI Communications Inc.'s John C. Malone, acquiring small cable operations for the cable giant. By the age of 36, Marcus had piled up a small fortune. He moved to Dallas in 1987 and started Marcus Cable in 1999

with a \$20 million investment from Goldman, Sachs & Co. Earning reputation for ferocious tenacity, Marcus quickly assembled the country's largest privately held cable-TV system.

The deal that put him on the map was a \$1 billion bid for most of Dallas-based Sammons Enterprises Inc. in 1995. Still a big player—but with financial backer from Hicks Muse as well as Goldman Sachs—Marcus pulled off a huge coup against a formidable TCI-led conso-

JEFF MARCUS

BORN 1946 Scranton, Pa.

EDUCATION BA, 1968, economics, University of California at Berkeley

HARDEST LESSON First startup in 1969, a cable marketing firm, failed miserably, a victim of runaway spending

BIGGEST SUCCESS Built giant cable-TV system, then sold it to Microsoft co-founder Paul Allen for \$2.8 billion earlier this year

FAMILY Married, two college-age children

INTERESTS Eating ("Some people eat to live, I live to eat"), bird hunting, reading biographies, traveling

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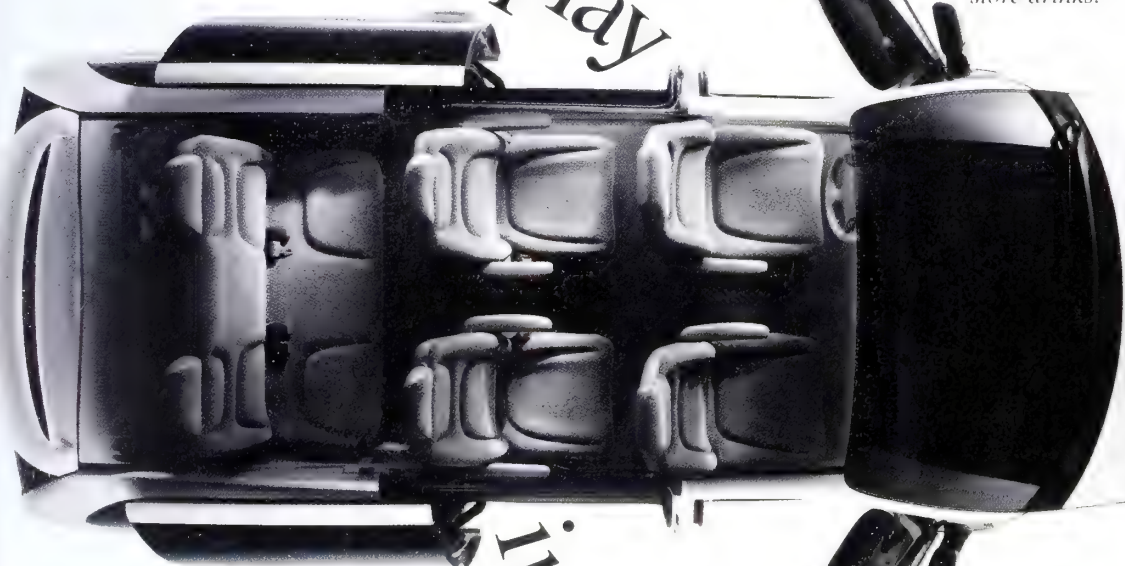


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Newport News Delivers Customer Satisfaction

Women, 18 to 45, looking for quality clothing at unbeatable prices. That's the target group Van Rhodes needs to understand. And he's not alone. As a marketing systems analyst for Newport News Catalog, a major catalog retailer and division of Spiegel Group, Rhodes asks, "Is a particular woman more likely to buy from the summer swimsuit catalog or the end-of-season discount mailing? If she buys from other companies' catalogs, what is the likelihood she'll buy from mine? How many mailings will it take to entice her to buy—and how many will be seen as overkill?"

Drowning in Spreadsheets

When Newport News Catalog empowered Rhodes to find a software solution that would give its marketing analysts a better tool for answering the questions, he turned to SAS Institute. Newport News Catalog had outgrown the legacy mainframe system that tracked catalog orders from its nine million customers. And the marketing department, in particular, was drowning in spreadsheets. As Rhodes recalls, "Over the years, as we grew and increased our catalog circulation, our marketing professionals were spending 80% of their time downloading, manipulating, and updating data. Too little time was left to effectively gauge the performance of each catalog and analyze the customer segments receiving the mailings."

In addition to keeping tabs on the 40 to 50 catalogs being tracked at any given time—and the 3,000 to 4,000 segments of each customer mailing—Newport News marketers were recently charged with tracking the success of a private label credit card. "That expanded the number of different ways we needed to look at our data by a factor of about eight or nine," Rhodes explains. "So, when we might have had two or three spreadsheets for each catalog, we now had 20 to 30 spreadsheets for each one. It became almost impossible."

That's when Rhodes looked to SAS software's customer relationship management, data warehousing, and data mining capabilities. "SAS Institute is interested in helping us develop a win-win solution," says Rhodes. "We have a very small IS department with no resources for research and development. SAS Institute has an impressively high percentage of revenue devoted to R&D—and we can tap into that base of knowledge."

Tracking Success Segment by Segment

According to Rhodes, "SAS software takes the tedious steps out of analyzing sales trends and forecasting catalog sales.

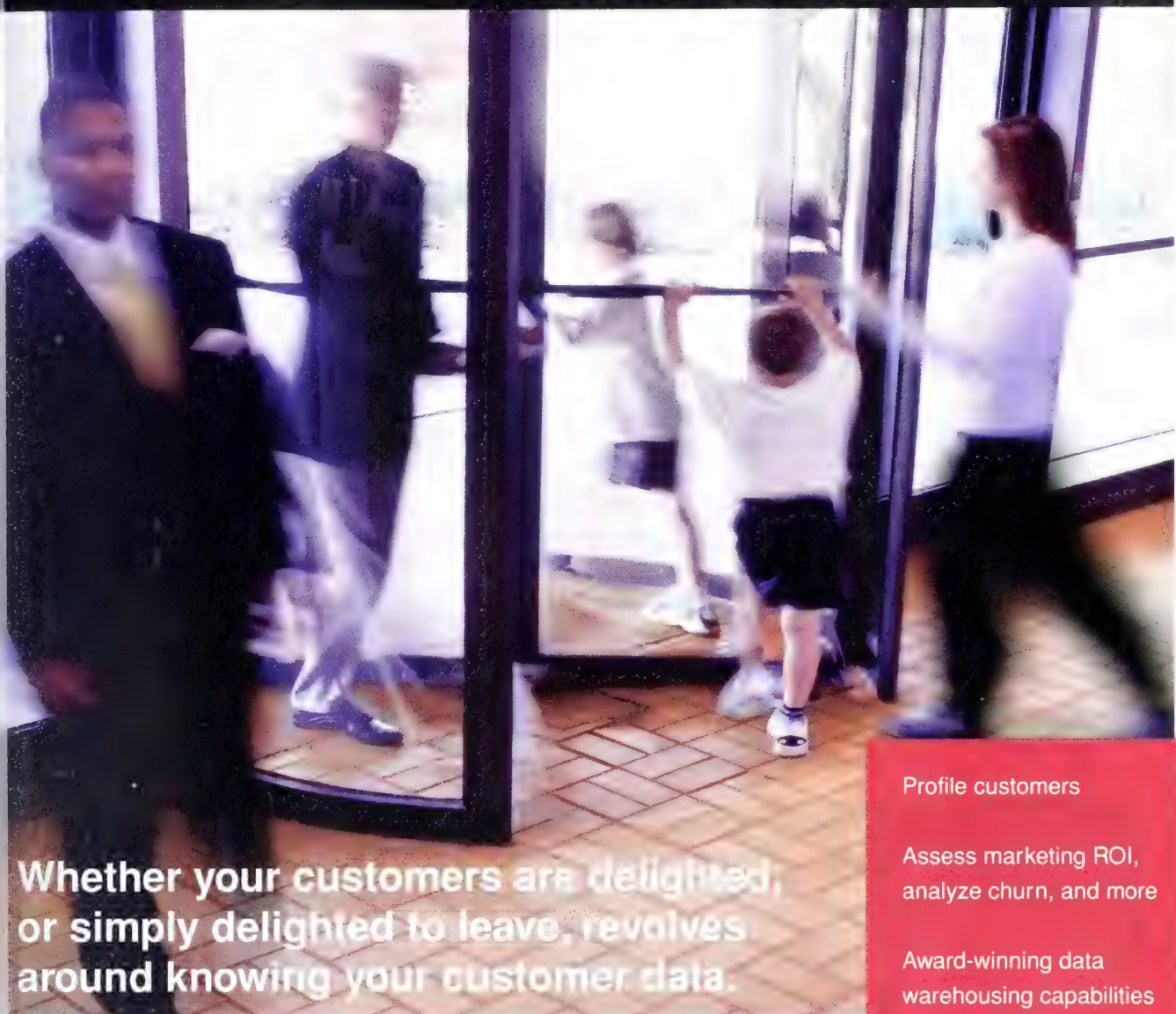


Van Rhodes, Marketing Systems Analyst, Newport News Catalog

During the day, order-entry operators take customer orders via our order entry systems. And every night, the orders are parceled out by SAS, with marketing information put into separate data marts for each catalog. When our marketing people come in each morning and bring up the system, the data has already been downloaded, massaged, and displayed the way they want. Decision makers just select the combination of reports they need and punch a button. SAS software generates the report right then and there—it's very flexible."

This flexibility allows Newport News Catalog's marketing specialists to track their success with each segment of each mailing, and to get as specific in comparisons as necessary. By tracking customer numbers, mailkey numbers, and catalog numbers, Newport News Catalog knows each customer's buying history as well as which lists the buyer name came from. By analyzing this data, Newport News can make educated assumptions as to future buying habit—which is key to creating customer relationships that last.

Rhodes says the return on investment in SAS software has been so great that Newport News is taking the SAS relationship to the next level. "We are re-engineering and expanding our data warehouse, migrating from our mainframe to a dedicated server, and utilizing SAS software at all levels. SAS software helps us access and manipulate our data to find the answers we're looking for. The only thing limiting us now is our own imagination."



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tium. "To the Sammons family, this deal wasn't just about money. It was about family, and wanting to keep the business in Texas," says Sanjay Patel, a former Goldman Sachs managing partner. "Jeff was very good at convincing the family to sell." Says TCI President Leo Hindery: "We looked like the outsiders, and he looked like a member of their club."

But there was more to it than that. To put his competitors off guard, Marcus floated rumors that he didn't have his financing lined up. To further throw off his opponents, he took his family on a trip to the Virgin Islands. "We had to sort of lie low and make them think we couldn't come up with the money," recalls Marcus. Then, holed up inside his hotel room for several days, Marcus scrambled by phone to persuade the Sammons clan to sell to him. Overnight, the deal vaulted Marcus Cable into cable's top 10.

"MY OWN PERSON." Now, Marcus has to prove himself all over again. He has already found himself at the center of controversy. In assembling the pieces of Chancellor, Marcus presided over the acquisition of two media properties that Hicks Muse held big stakes in. And since his golfing pal, Thomas O. Hicks,

and Hicks's LBO firm have backed Marcus over the years, some Chancellor investors question whether Marcus is acting as an independent CEO or merely doing Hicks Muse's bidding. "Jeff's a very talented guy who's good at getting things done," says Storm Boswick, a vice-president at J&W Seligam & Co., which has a 2.7% stake in Chancellor. "My only concern is that Tom [Hicks]

Scott K. Ginsburg, chose to resign rather than pursue a diversification strategy into pricey nonradio deals. Chancellor, meanwhile, has been the target of at least one investor suit charging that it paid too much for LIN. Says Boswick: "It was a terrible deal." Since the LIN transaction was disclosed, Chancellor's stock has fallen 45%, to 28.

Marcus is quick to dismiss concerns that he is acting on behalf of Hicks Muse. "I am my own person, and I am attendant to all the shareholders' best interests," says Marcus, adding that "Hicks Muse has \$2 billion invested in this company... and its interests

STORM CLOUDS Some investors are irked about the \$1.5 billion Marcus paid for LIN Television. "It was a terrible deal," says one

might ultimately be making the calls."

Boswick and others are particularly irked about the price Chancellor paid for LIN Television, a Providence, R.I.-based broadcaster. Hicks Muse acquired LIN in March for \$1.9 billion, only to sell two stations to NBC for \$815 million and hawk the rest of the company to Chancellor in July in a stock and cash deal then worth \$1.5 billion. Industry sources say Chancellor's former CEO,

are totally aligned with other shareholder interests." And Tom Hicks stresses that all deals must be approved by outside, independent directors. Moreover, "we are long-term [Chancellor] investors," he says. "We want the company to do well." No doubt. But life sure is getting more complicated for Marcus. Still, it beats hauling trash for a living.

By Stephanie Anderson Forest in Dallas, with Ronald Grover in Los Angeles



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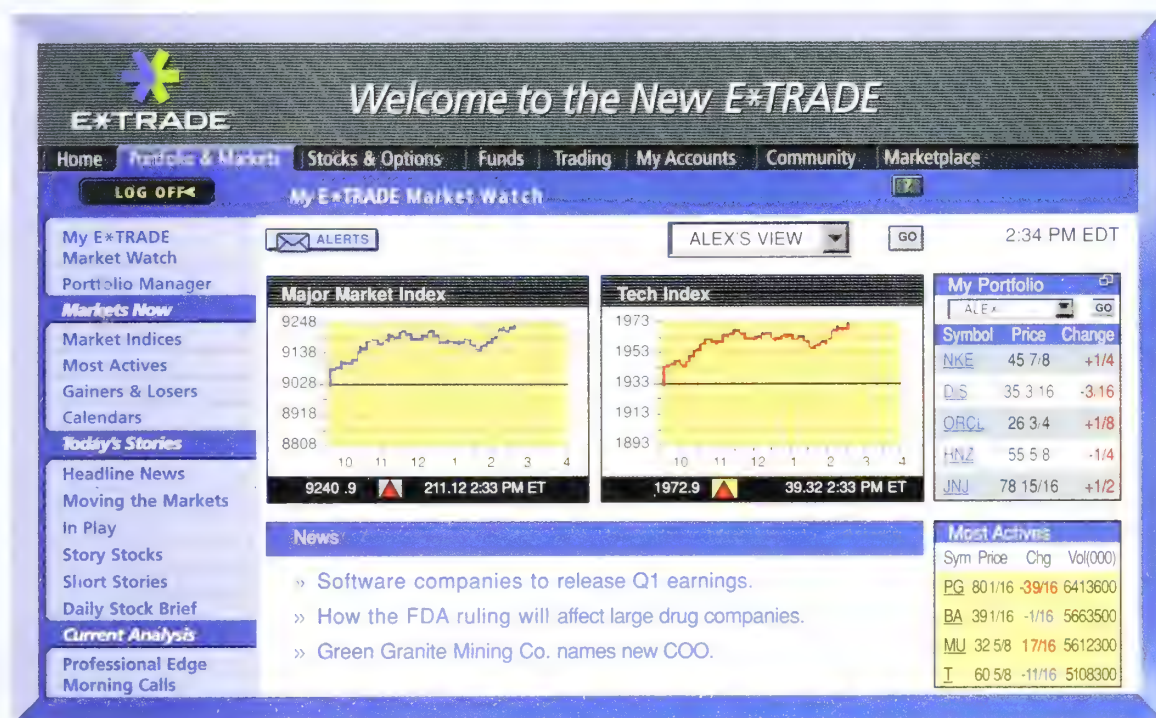
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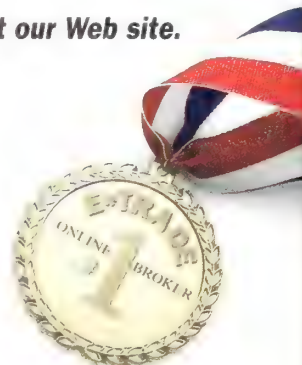
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Reinventing Education

Computers can **make a** world of **difference** in our nation's education system.

They just can't do it on their own.

We don't just send computers to schools, we send people, too: experienced scientists and problem solvers. They help educators apply technology in ways that make profound improvements in the way schools are run. In Cincinnati, a team from IBM helped teachers design a new program that tailors courses and schedules to the unique needs of individual students, finally putting an end to "one size fits all" education. The result: better schools, smarter kids. To find out more about IBM's Reinventing Education program, visit us at www.ibm.com/IBM/IBMgives

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"It appears that we're well on our way to putting every school and classroom on the information superhighway by the new millennium, but we have to make sure that everyone has the opportunity to access the vast, new resources of cyberspace via the Internet and other telecommunications."

*—Al Gore
Vice-President of
the United States*

Meeting Challenges, Achieving Solutions

WHY TECHNOLOGY IN EDUCATION MUST BE EVERYBODY'S BUSINESS



DAVID G. FERM



CHARLOTTE K. FRANK

America's future success depends on the ability of today's students to meet national demands for high-tech workers, educated consumers, and responsible citizens. No one can be left behind. If all students do not have access to technology opportunities, their future, and indeed the future of the nation, is in jeopardy.

Monumental challenges face us as we seek to prepare America's students for this high-tech future. How much technology should be used in learning? How can technology be integrated into the educational core of the classroom? How can communities work with local corporations to organize NetDays? How can we demonstrate bottom line results from using technology?

It is a job that no one stakeholder group can finish alone. Teachers, parents, supervisors, students, employers, and employees must take responsibility to ensure that challenges are overcome, solutions are found, and that effective models for instruction are institutionalized.

Find out in **Smart Links: Education & Technology** how corporate America, alongside other stakeholder groups, has begun to meet these challenges through successful systemic school reform efforts. In addition, through the section's advertising support, Business Week and The McGraw-Hill Educational and Professional Publishing Group will identify 10 schools that will be the recipients of The Tenth Annual Business Week Awards for Instructional Innovation. These schools will be chosen as the ones which best exemplify the way that technology is infused into the curriculum.

David G. Ferm

Charlotte K. Frank

Most Americans enthusiastically agree that students, teachers, schools, and communities must have access to technology tools for teaching and learning. When they are appropriately introduced, applied, and used, technology tools play key roles in achieving progress.

In order to achieve progress, there are five challenges that must be met:

- ensuring technology literacy for all;
- meeting national demands for high-tech workers;
- closing the gap between "haves" and "have nots";
- thinking of technology as an investment rather than a cost, and;
- making sure that efforts demonstrate results.

As community stakeholders, are businesses using their technology "know how" and resources to foster, guide, and strengthen teaching and learning?

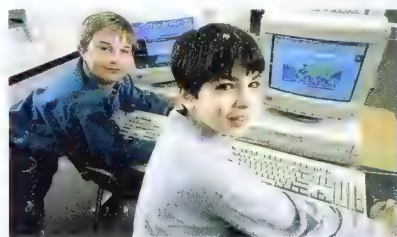
THE FIRST CHALLENGE: Technology Literacy

Avoiding "Business as Usual" to Manage and Deliver Instruction

Schools are central to the achievement of technology literacy, yet they are mostly on the sidelines of this information revolution. Tying or pasting technology to usual teaching methods and management

of instruction barely scratches the surface of what is possible and limits a school's capacity, efficiency, and effectiveness to manage and deliver instruction.

At the **Arthur Andersen Community Learning Center**, in California's Alameda Public School District, technology is used to help reinvent the system. This School of the Future, a modern version of a one-room schoolhouse, features a complete learning environment. Through a systems



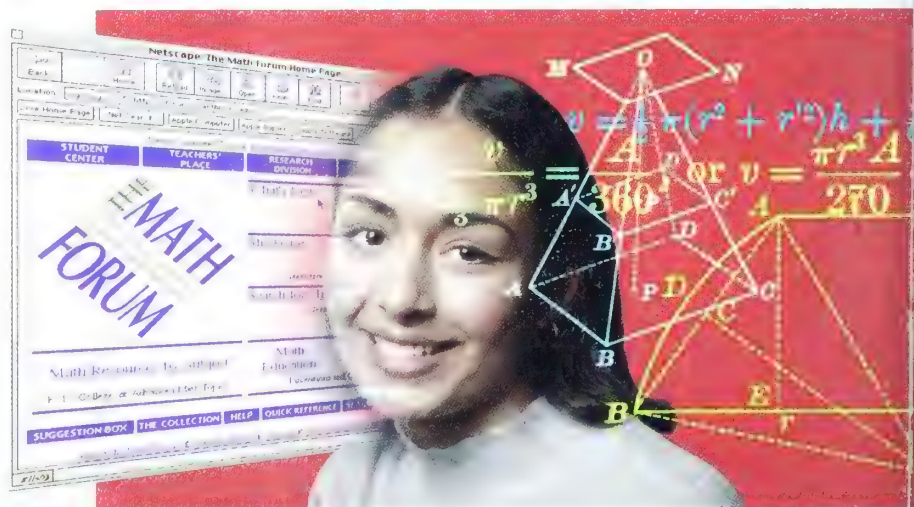
IBM has awarded the Charlotte-Mecklenburg School District (NC) a Reinventing Education grant to implement Wired for Learning.

quality control approach to education, chalk and boards are replaced with an electronic bulletin board of networked computers, allowing a group of students to participate simultaneously.

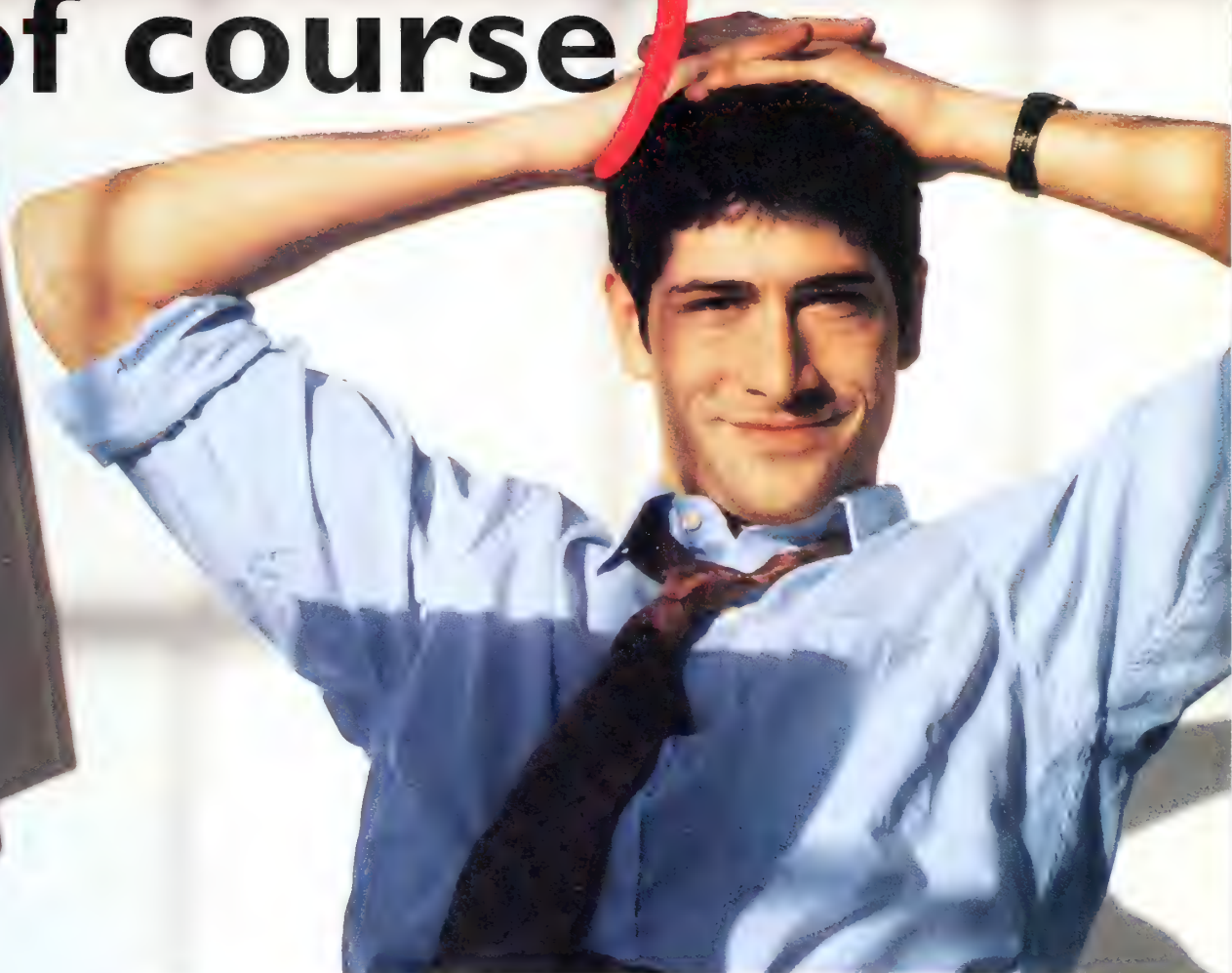
Connecting Instruction and Learning to Global and Real-Life Resources

A Global Strategy Group poll found that although 71 percent of teachers said computer training was available to them, only 48 percent had access to training for integrating technology across all subject-area disciplines and into classroom instruction.

In partnership with educational organizations, **MCI** has developed MCIMarcoPolo, a program offering a Web site, with



of course



Introducing the AT&T Learning Network®

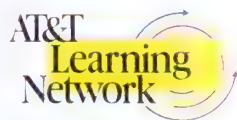
Virtual Academy

How can educators meet their professional development requirements?

Online, of course, with help from the AT&T Learning Network Virtual Academy. This centralized resource of online courses is designed to help educators effectively integrate technology into their curriculum, while updating their professional credentials on their terms - anytime, anywhere.

In collaboration with institutions like Penn State University's World Campus and T.H.E. Institute, a division of *T.H.E. Journal*, the AT&T Learning Network Virtual Academy gives teachers the best choices in Web-based courses. These online courses range from continuing education units to college credits; from e-mail to video teleconferencing; from free to fee-based.

The AT&T Learning Network Virtual Academy is the latest in a series of programs presented by the AT&T Learning Network. For more information visit our Web site at www.att.com/learningnetwork or call 1-800-354-8800.



It's all within your reach.®

high-quality resources. MCIMarcoPolo (www.mci.com/MarcoPolo) provides educators and families with a portfolio of accurate, safe, curriculum-based Web sites for science and mathematics resources, history, social studies, English, foreign language, art history, geography, current events, and economics.

The Virtual Trade Mission (VTM) (www.virtualtrademission.org) is an interactive experiential learning program, created through the private sector leadership of the President's Export Council. Developed by a consortium from the public and private sectors, VTM provides middle and high school students, educators, and workers with a multimedia introduction to emerging markets. Some of the participating VTM partners and sponsors include: The Center for Strategic and International Studies, **The Boeing Company, United Airlines, UPS, TRW Inc., AT&T, Motorola, Inc., General Electric, Hughes Electronics, Raytheon Company, Fluor Corporation, O'Gara-Hess & Eisenhardt Armoring Company, MCI, Maidenform, Aquatics Unlimited, Texas Instruments, Autodesk, United Steelworkers of America and International Brotherhood of Electrical Workers.**

State Farm Insurance Companies' Good Neighbor Award recognizes primary and secondary teachers for innovation, leadership, and involvement in their profession. With the assistance of national teachers' organizations in the nomination and selection process, the company awards a \$5,000 grant to the educational institution of the recipient's choice; winning teachers are featured in local and national publications. These teachers have integrated technology into classroom instruction: a high school art class in Flossmoor, Illinois is exposed to 3D graphics software and Internet access to the art world; and kindergarten/first grade classes in Haverhill, Massachusetts, use computers while working with parents to transcribe student stories into written words.

Strengthening Administrators' Technology Skills

As many as 50 percent of teachers have little or no experience with technology in the classroom, says McKinsey & Co. New and experienced teachers need training to explore new ideas and materials;

CASE IN POINT:

A County-wide Process to Effect Change



he Los Angeles County Office of Education serves more than 1,700 schools with 1.6 million K-12 students. A collaboration of 81 school districts in Los Angeles County, together with public and private sector groups, developed the Technology For Learning (TFL) initiative to:

- facilitate hardware procurement;
- train 60,000 teachers and 30,000 parents and community members; and
- connect 50,000 classrooms in Los Angeles County to the information superhighway.

Early results cite increased teacher proficiency in the use of technology; integration of technology into classroom instruction and curriculum; and mentor proficiency as teachers assist colleagues in their schools, and other schools within the district.

Businesses Are Key Partners

To effect county-wide changes at this scale is an enormous effort. **Apple Computer, Inc.** provided software for teaching, expertise on staff development, and help in leveraging technology as a tool. **AT&T** helped establish 25 AT&T Learning Network Technology Centers that focus on training. **Microsoft Corporation** and **Davidson Software** provide software for teacher training and curriculum and instruction while **IBM** donated a technology lab, including hardware and software. **Cisco Systems, Inc.** has placed one of its Networking Academies into each of the technology consortia to equitably distribute student networking training.

follow-up consultation; opportunities to exchange ideas with colleagues; and observe other teachers using technology.

Nortel/Northern Telecom created a Teacher Training Program to address the computer technology needs of North Carolina teachers. More than 40 Nortel volunteers spent Saturdays training teachers and administrators at the company's Research Triangle Park training facilities. More than 3,800 teachers have been trained—at no cost to them.

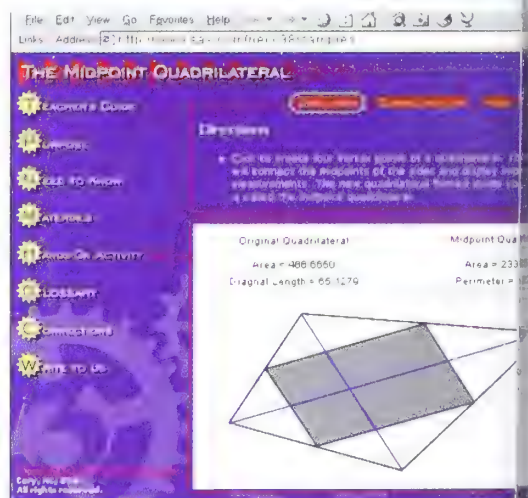
Hewlett-Packard, in partnership with **Intel Foundation** and **Microsoft Corporation**, supports a regional teacher effort, "Applying Computers in Education." Approximately 1,400 teachers in grades 6 - 12 will be trained to integrate the use of computers with existing curriculum in Arizona, California, New Mexico, Oregon, Texas, and Washington.

The companies retained the Institute of Computer Technology (ICT) in Sunnyvale, California, to train teachers simultaneously in

multiple locations; the companies will pay for teacher stipends.

This is a turnkey training model. Master teachers from each of the regions serve as ongoing trainers. They will train teachers in their area to integrate computer technology into their existing curriculum at workshops and a summer institute, and ICT's Web site.

Apple Computer, Inc. provides a staff development program that can take



SAS Institute's Educational Technologies Division delivers core content via a web browser.



**Fairfax County has one of the best
educated populations in the country.**

The numbers stack up this way: 56% of the adults hold college degrees. 91% of their children pursue post-secondary study. 89% take the SAT exam, scoring 72 points higher than the national average. We have a science and technology magnet school that regularly produces more National Merit Scholarship semifinalists than any other. And a university, George Mason, that was the first to offer a doctorate in IT. If your business depends on bright, creative minds, it's almost a no-brainer: Call 703-790-0600 or visit our Web site. And move your business to Fairfax County.

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beginners and upgrade their technology skills beyond basic technology integration to advanced integration or even innovation. Apple's Debra Rein notes that the program encourages teachers "to think of the computer as a tool for teaching and learning, and to create ways to use technology to address learning objectives. Teachers then become models and mentors who can share their knowledge with their peers." Apple Staff Development materials enable teachers to integrate technology into classrooms—no matter which computers they use. The Apple Staff Development (www.apple.com/education)

is tailored to meet specific teacher, school, or school district needs.

Through the Superintendents' Leadership Network (www.bellsouthcorp.com/bsf/initiatives/superintendent.htm), the **BellSouth Foundation** serves as partner and administrator with the Center for Leadership in School Reform (CLSR) in Louisville, Kentucky, a national, nonprofit organization. The Network serves as a model for developing the leadership competencies of superintendents in the South.

Superintendents agree to work individually on education in their home districts; in sub-groups on state-specific



Arkansas School for Mathematics and Sciences students use data acquisition software for physics experiments.

policy issues; and together on regional and national priorities. On-site support, including technology training, is provided by CLSR, and BellSouth, among others.

Expanding Community-Based Teaching and Learning

Eighty percent of the American public reported that teaching computer skills is "absolutely essential." Yet the National PTA found that many parents are fearful about technology.

The **US West Foundation's** Widening Our World (WOW) Program uses mobile training units to provide needy communities with computers, computer training, and help in developing community-based labs in schools, libraries, low-income housing, and community centers throughout US West's 14-state service area. In Englewood, Colorado, the Foundation's Technology Training Academy trained 69 teams and sent each of them back to their communities with a network server, four desktop computers, and \$15,000 in seed money to initiate local programs and fund training. Students team with adults to train other adults.

Nationally, **FamilyEducation Network** (FEN), the Internet division of FamilyEducation Company, offers schools free customized Web sites to create community-based home-school connections (<http://familyeducation.com>). Web site components include online access to information and resources from each school's customized Web site; and regularly updated content geared toward parents and educators.

In this effort, FamilyEducation Network is allied with such grassroots education organizations as the American Association of School Administrators (AASA), the National PTA, National School Boards

CASE IN POINT:

"A Software Company Creates an Academy"

The Academy's Purpose



In 1996, **SAS Institute, Inc.** (the world's largest privately-held software company) established Cary Academy, a comprehensive, coeducational college preparatory program for students in grades 6-12. As a result of the educational technology needs identified when bringing the school online, the Institute created an Educational Technologies Division that focused on the development of educational software. Together with Academy teachers, this division works to create interactive, multimedia courseware aimed at middle school and high school students; and school administration applications. Eventually, the products will be available through a browser.

Dr. James H. Goodnight, President & CEO, SAS Institute: "The curriculum materials that SAS Institute has put together contain Web sites all over the place...Part of the process of the development group is to screen all Web sites around the world. More than 1,000 CD-ROM titles and 15,000 Web sites have already been visited to search for content."

Educational Results

The program has extended teachers' professional skills: they are using technology daily to communicate with students and parents during and after school, and in courseware units focused on multimedia presentation of content across all subject areas.

Students say learning is more fun. Their reports are increasingly well-organized, readable, and incorporate simulations, graphs, and tables. Study guides that have been developed are time-savers if students are sick and need to stay abreast of work assignments.

Parents are checking their children's grades and homework assignments on a daily basis!

Administrative Applications

Administrative applications that use SAS software focus on a student information system that allows data to be entered or imported once and then used as appropriate for daily school functions. Currently being customized for public school systems, the software allows for the input and management of data as well as communication among faculty, staff, students, and parents. For further information, see these Web sites: (www.caryacademy.pvt.k12.nc.us) and SAS Institute, Inc. (www.sas.com/inschool).

Welcome to Battlesfield. Population: 23

Pictured here are some of the "founding fathers" of Battlesfield. They're the school kids from Ms. Garvilla's class, the ones who created their very own town made entirely of LEGO® bricks.

Ms. Garvilla inspired her grade-schoolers to build this burg, complete with post office, a town hall, a factory, hospital, baseball fields, and all the other necessities of life, so that they might visualize the range of buildings and services that societies need in order to function.

Battlesfield (a name the kids picked from the atlas) was constructed block by city block during the course of the school year, added to and altered as new concepts were introduced. This endeavor not only "laid the foundation" for the teaching of social studies, it also enabled young children to experience a feeling of community spirit.

For teaching her students how to turn a bunch of buildings into a community, State Farm is pleased to present the Good Neighbor Award to Lorraine Garvilla, along with \$5,000 in her name to Lawrence School of Sussex, New Jersey.



Good Neighbor Award

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Association (NSBA), and partners such as the AT&T Learning Network, Fleet Financial Group, Inc., and Scott Foresman-Addison Wesley. With the development of a long-term strategic partnership between AOL and FamilyEducation Network, FEN becomes an anchor tenant in AOL's Research & Learn and Family Channels.

THE SECOND CHALLENGE:

A Qualified Workforce

Businesses are addressing current and long-term needs for skilled, qualified workers who can demonstrate the technical, creativity, problem-solving, and learning skills required in the new economy. A study by the Information Technology Association of America and the VA Polytechnic Institute determined there were 346,000 vacancies for programmers, systems analysts, and computer engineers/scientists in IT/non-IT companies with more than 100 employees. This rate, representing about three vacancies per company, did not vary significantly according to company size, or location, or industry.

Related Worker Educational and Skills Requirements

While the economy will continue to generate large numbers of jobs at all educational levels, the increasing role of technology means that at least half of the fastest-growing and higher-paying opportunities will require more extensive education, training, and experience. More specifically, employment in occupations requiring an associate degree or higher will grow considerably faster than those with lesser educational requirements. Growth rates from 1996-2006 will range from 7.4 percent for occupations generally requiring post-secondary vocational

training to 25.4 percent for those requiring a bachelor's degree.

Since the inception of the Hewlett-Packard (HP) E-mail Mentor Program (<http://mentor.external.hp.com>), more than 3,000 HP employees from around the world have been matched with 5th-12th grade students in the United States, Canada, Australia, and France. A supervising teacher guides students and mentors. Currently, all training and technical assistance for mentors is online.

The program enables employees, who work the "third shift" or are salespersons, to spend 10 minutes a day in K-12 education without leaving the HP site.



CASE IN POINT:

Charlotte-Mecklenburg: A Community Wired for Learning

To stretch the boundaries of school and learning and strengthen the connections between schools, homes, and the community, the Charlotte-Mecklenburg School District in North Carolina and the IBM Corporation joined forces to create a new technology called Wired for Learning.

In 1994, IBM awarded the District \$2 million through its Reinventing Education grant program, an initiative designed to help spur and support fundamental, systemic change in U.S. public schools. Two of four planned workplace magnet schools, built within the Governor's Village, Charlotte's new complex of break-the-mold schools, were seen as the perfect sites to begin implementation of Wired for Learning.

Wired for Learning employs Lotus Notes/Domino technology to enable secure communication and collaboration through the Internet. Wired for Learning allows the

transmission of text, sound, and video within and between classrooms and schools as well as to networked homes, community centers, and a local science museum. As a result, parents—using a protected password—now access their children's teachers to talk about student assignments on a regular, daily and weekly basis, not just at scheduled appointments. While the menu of activities is customized for each Reinventing Education user, the primary focus of communication is on student work and learning.

Using the software, students work together on the same project from different locations. Teachers work together to develop lesson plans and student assignments online and search the Internet for assignments that improve upon the existing curriculum.

Hundreds of parents have received training on the basic use of computers and how to work with the new software. Once registered and approved, university professors, museum historians, and other concerned citizens can serve as online mentors or tutors from a community center or from their home or workplace at their convenience.

Q

**Who is helping
schools fund *and*
tap the full power
of new technology?**



A

Through the Federally mandated Universal Service Fund (USF), companies like Bell Atlantic are contributing millions of dollars to help K-12 schools and libraries purchase vital new technologies for:

- Basic and advanced telecommunications services
- Internet access
- Internal classroom connections

The second application cycle for USF funding will open in the fall of '98 at www.slcfund.org for discounts beginning July 1, 1999. And with Bell Atlantic as your technology partner, every dollar buys even more — because we'll contribute *more*: More expertise on how to leverage our unique network-based solutions to connect your district's buildings. More access to learning opportunities across town or around the world. More hands-on guidance to put your new solutions in place. And more of the commitment we've *always* shown to partnering with educators.

That's why, when it comes to helping you teach children all they must know to shape the future ...

Bell Atlantic has more of the right answers for you.

Our Technology Planning Guide explains the USF process and Bell Atlantic's key solutions. For your FREE copy, or for more information, visit us at www.BellAtlantic.com/edk-12



Time zones and geography mean nothing; students in Colorado can be matched up with employees in Hong Kong. As a result, students take more responsibility for their own learning, and show improved academic performance, particularly in science, mathematics, reading, and writing.

THE THIRD CHALLENGE:

Access and Equity

The U.S. Department of Education reports that in 1997, 78 percent of schools used the Internet, double the 1994 rate. From January 1995 to June 1996, the number of schools with Web sites on the Internet jumped to 1,850. Despite these gains, many students and teachers, in urban and rural schools with high concentrations of children who fall below the poverty line, continue to have less Internet access.

Access Supports Learning

Through Oracle's Promise, **Oracle Corp.** pledged \$100 million to bring 3,000 affordable and easy-to-use network computers to poorer public schools throughout the United States. These computers permit access to the Internet, e-mail, and word processing functions. Approved schools receive network computers with peripherals, laser jet printers, a server, and a teacher training package (<http://www.oracle.com/promise>).

The AT&T Learning Network helps families, schools, and communities use technology. This free online support service

CASE IN POINT:

Teacher.training@microsoft, a National Teacher Training Model



icrosoft's teacher.training@microsoft (<http://www.teachertraining.com>) addresses the need for teacher training to ensure that teachers receive the preparation and support they need to effectively integrate information technologies into their teaching.

Business/Higher Education Collaboration

To achieve these goals, **Microsoft** has teamed with more than 1,000 state department of education and educational college sites to create and support professional development training programs for technology. In the 1997-98 school year, more than 350,000 educators were trained at these sites.

How the Program Works

When applications have been approved, Microsoft provides free software, resource, and instructional materials. Microsoft also provides the licenses needed to use the software in teacher training laboratories, information on how to evaluate Microsoft technology, and the latest drivers and patches to keep systems running smoothly.

includes an Internet 101 teacher tutorial; a Web tour created to guide teachers through various education-related uses of the World Wide Web; AskLN, a mentoring program for teachers; and links and pointers to help direct teachers and families to online education and resources.

More than 250 K-12 public and private schools participate in Toshiba's Notebooks for Schools program. Developed with Microsoft, it provides round-the-clock access to portable laptop computers. Through this program, **Toshiba America Information Systems Inc.** offers notebooks with Microsoft Office Professional,

high-speed modems, and toll-free technical support for users. Computer purchases for students, parents, and faculty are simplified through Toshiba's special financing program.

Access for Special Populations

The Mattel Family Learning Program (MFLP), developed through the partnership of the **Mattel Foundation** and the Alliance for Technology Access provides the disabled with the hardware, software, and technical support that permits users to go online, share resources, and find pen pals. The MFLP also supports schools and community centers to enable them to develop after-school, family involvement programs. Additionally, teachers have benefited from specialized training provided by ATA.

Access Improves Home and School Communication

Technology provides access to learning opportunities by expanding and improving communications between families and schools. **The American Business Collaboration for Quality Dependent Care (ABC)**, a national coalition of 22 companies, including **GE Capital Services**, **Hewlett-Packard Company**, **IBM Corporation**, **Lucent Technologies**, and, **NYNEX/Bell Atlantic**, addresses the diverse needs of employees through a commitment to invest resources where their employees live and work.

One ABC program, The Bridge Project, developed by WFD, Inc., uses

CASE IN POINT:

Cisco Networking Academy Program



he Cisco Networking Academy program (www.cisco.com.edu) has been established in 946 high schools, colleges, and technical schools in 47 states and in Washington, D.C., and in several countries around the world. The program teaches students how to design, build, and maintain local and wide-area computer networks. As a result, schools will have technical support and resources to supplement limited school funds and a qualified network of support personnel (administrators, designers, and troubleshooters).

The program offers 280 hours of a supervised multimedia, Web-based curriculum, a complete suite of lab equipment, teacher training; and technical support. Student classroom time is divided between using the multimedia curriculum, and actually configuring and operating real network equipment in the lab. Students learn skills essential to network administration, and build reading, writing, and math skills. Students who demonstrate 80 percent competence, in a test constructed by academic and technical experts, acquire a certificate that shows they are qualified to be standard network technicians and junior network administrators.

It's one thing to wire up your schools... but how do you fire up your students?



See for yourself at www.sas.com/wired SAS Institute surveyed more than 25,000 teachers to find out what they're looking for in classroom software. Their #1 answer? *Curriculum content*. That's why our School Technologies are based on strong content—using multimedia to proactively engage students and help promote the critical thinking and problem solving skills they'll need in their future careers. Visit us today for a demo at www.sas.com/wired

*Enhance learning
through effective
use of technology*

*Deliver timely,
researched materials
that align with
your standards*

*Provide teachers
with more time
for students*



voice-messaging technology to help connect parents and teachers. Sponsoring companies provide funding for schools to acquire state-of-the-art voice-mail technology (in multiple languages if necessary); training; and strategies to communicate the project to employees, other parents, at the schools, and the community-at-large. Results show that 50 percent of parents access the system every day, teacher-parent communication increased on an average of 487 percent, and academic achievement and attendance improve. Approximately one-half of participating employees say they are now more involved in their children's education; their children are completing more homework; and the project has helped them balance work and family responsibilities and reduce family stress.

THE FOURTH CHALLENGE: Thinking Investment, Not Cost

U.S. schools are expected to spend \$5.2 billion on educational technology during school year 1997-98, a 21 percent rise in

GOOD PRACTICES

Corporate volunteers do high-tech "barn raisings" called NetDays that install computers in schools and offer ongoing support. Originating in California, the effort is spreading across the country and around the world.

spending from 1996-97. Increased spending on instructional software is projected at 49 percent and on hardware (mostly personal computers and servers) at 41 percent. In 1995, schools spent \$6 million for online and subscription-based services; this is expected to double by 1998.

Concerns have been raised that school districts are throwing money away on one-time technology expenditures, expecting quick solutions to technology needs. In reality, funding will be a long-term challenge.

In response to the federal government's Technology Literacy Challenge, states and school districts have already developed technology plans that include funding to upgrade

CASE IN POINT:

Leveraging Resources at the Local/County Level

In Charlotte County, in rural Virginia, the ratio is three students for each computer. All students have daily access to the latest instructional, multimedia-networked technology equipment. The schools' 23 Integrated Laser Disc instructional labs use ALS (**Advanced Learning Systems**) and CCC (**Computer Curriculum Corporation**) software and are online to major universities. Students in the Early Learning Center work daily in their 20-station computer lab.

Why does this work considering that 23 percent of the county's households exist below the poverty level? The school system developed a company called Statesmen Computers, the county's only high school, classroom-based computer manufacturing company. This company, owned and operated by the Charlotte County Board of Education since 1994, designs, manufactures, sells, installs, and services computers and related equipment to businesses, industries, other school districts, parents, individuals, and county and state government agencies. Business and community partners in this venture include large industry, family-owned markets, small sawmills, and other local-area business. Money earned by the company is reinvested into technology for the school district.

computer equipment, training, and community-based learning. The major source of technology support continues to be the school districts themselves, followed by state and federal government funding.

At regional, state, and local levels, collaboration among stakeholders can more effectively connect communities to address issues concerning ongoing, technology requirements. **BellSouth Foundation**—through a "TechKNOWLEDGEy" conference—assembled southern school leaders to explore ways to fund school technology. Then BellSouth Foundation (www.bellsouthcorp.com/bsf/technology/

better.htm) created ways for selected school districts to receive technical assistance. The expected outcome of this effort will be a set of tools and case studies to assist any school with budgeting issues.

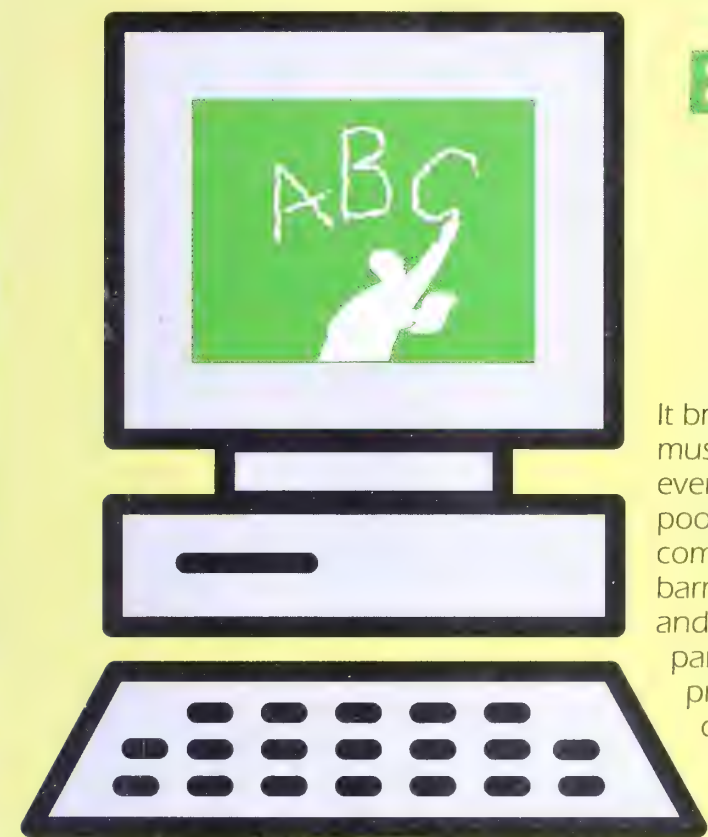
THE FIFTH CHALLENGE: Demonstrating Results

The results of technology's impact on education are still not resolved. Knowledge about the kind and amount of technology used in schools, how it is used, the results of its use, the kind and degree of training and support teachers need, and true costs has been limited by a lack of major



In a world based on the power of information, computers and other educational technologies support traditional learning and encourage exploration and new understanding.

Technology is the Blackboard of the Future.



It brings the world's finest museums and greatest libraries to every student, even those in the poorest, most rural or remote communities. It breaks down barriers of language and disability and allows all students to be full participants in the learning process. It offers the promise of challenging courses in subjects like physics and calculus in every high school in America.

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or *Parents Guide to the Internet*,
contact the
U.S. Department of Education
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CASE IN POINT:

John J. Pershing Intermediate School, Brooklyn, New York



ohn J. Pershing, an urban public middle school with nearly 1,400 students, is a miniature United Nations in which one-third of the students are recent immigrants. Two years ago, Pershing recruited business, community, and local government partners to help them gain access to a fully networked technology infrastructure. This infrastructure would support the development of hands-on, problem-based, student-centered interdisciplinary curriculum models that integrate computer and telecommunication technology. Here's what happened.

- **Sun Microsystems** provided a complete Java Station Computer Lab and the server to network the computers.
- **Hewlett-Packard** provided a complete computer lab, including printers and technical support.

- **Microsoft** provided the software for the lab.
- **Fore Systems** provided ATM switches that enable all students to simultaneously access the Internet, send and receive e-mail, and to videoconference.
- **Electronic Techniques Inc.** contributed half the cost of the sound and data projection system.
- **Cablevision** provided TV/VCRs for every classroom.

After two years:

- All students have regular access to computers and telecommunications training during and after school.
- More than 60 percent of the school's teachers are computer literate.
- The student:computer ratio was reduced from 16:1 to 6:1.
- Students have become literate in computer, telecommunication, and multimedia technology as well as the fundamentals of computer repair and software configuration.

studies that demonstrate a tie between technology and student achievement.

The initial U.S. Department of Education study of nine technology-rich schools showed educational gains for all students regardless of age, race, or parental

income. Key features of these schools' success appeared to be: concentrated, explicit planning among school leaders, families and students to create learner-centered environments; clearly articulated goals and challenging standards for

student achievement; the restructuring of the school to support the learner-centered environment and achievement of standards; and nearly universal access to computer technology. Examples of sites that have shown results are in urban and



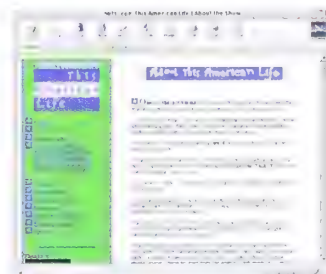
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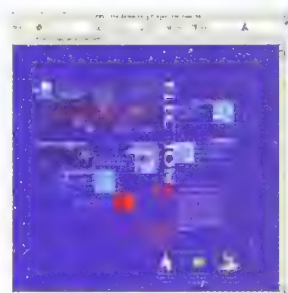
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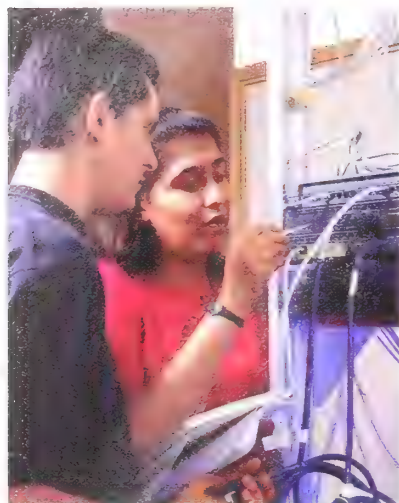
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Two Cisco Networking Academy students from Thurgood Marshall High School in San Francisco, CA review the wiring on a Cisco router.

rural areas, such as the Pershing Intermediate School, NYC, Charlotte County, VA (see Cases in Point), and the Union City, NJ school district.

From Christopher Columbus Middle School, Union City, NJ
Bell Atlantic Corporation along with Union City (a school district with a history of failing students) created the Union City Interactive Multimedia Education Trial to integrate technology into the curriculum. Bell Atlantic updated Columbus School's technology, provided computers in classrooms and in the homes of both students and teachers, and also supported computer training for teachers who then conducted sessions for parents. By 1998, the average reading scores increased 53 percent, math scores increased 30 percent, and writing scores increased 40 percent. Student attendance is high. The school district has assumed responsibility for expanding the project to other schools throughout the district.

From Charlotte County, VA
At the high school level, 99 percent of the students have passed the State

Literacy Passport Testing Program. Fifty-four percent of the high school's juniors and seniors participated in the Dual-Enrollment Program, enrolling in and passing 227 college classes during the 1996-97 school year. At the elementary and middle school level, 81 percent of children who participated in the district's early childhood programs scored above the national average on standardized tests in reading and math.

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Dr. Susan Otterbourg is a Durham, NC-based author and consultant for business and education partnerships.

CASE IN POINT:

Leveraging Resources at the State Level

The National Consortium for Specialized Secondary Schools of Mathematics, Science & Technology has a membership of 58 schools in 23 states. The Consortium serves educators and 30,000 students in specialized state- or district-chartered member schools and affiliated organizations that focus on preparing students for leadership in mathematics, science, and technology.

At first glance, these public-supported specialized high schools, which educate some of the "best and the brightest," might appear to be exclusive. A closer look found that, to the contrary, the schools had leveraged their resources with other educators, schools, and students.

The Alabama School of Mathematics and Science (www.asms.net), along with **Ciba Specialty Chemicals**, developed a two-county Lab on Wheels outreach program for nearby middle schools that allows ASMS staff to transport portable equipment to schools that do not have fully-equipped science labs on campus; and help middle school teachers incorporate experiments and the program's Internet resources into their daily teaching.

The Central Virginia Governor's School (www.cvg.s.k12.va.us) partners with more than 140 businesses, health-care facilities, and government agencies to offer opportunities for regional middle school students and their teachers to participate in events that feature technology applications in mathematics and science.

The Illinois Mathematics and Science Academy's

(<http://www.imsa.edu>) outreach efforts serve teachers throughout Illinois with support from partners such as **The Tellabs Foundation**. Students and faculty used a grant from this Foundation to help create the Tellabs Studio for Professional Development on the IMSA campus as the central hub for statewide professional development for teachers.

The Arkansas School of Mathematics and Sciences (<http://www.k12.asms.k12.ar.us>) will enter into a partnership with **Wellsco**, a consortium of corporations, to extend distance learning offerings across the state. ASMS will use existing resources as a springboard to seek additional business partners to serve underserved schools and students with math, science, technology, and humanities courses.

The North Carolina School of Science and Mathematics (www.ncssm.edu) provides technical assistance, and helps raise funds for the Educational Futures Center hub (located at NCSSM) with seven cyber campuses that act as resource centers to rural, underserved areas throughout the state. Jump-started with a major grant from **Burroughs Wellcome Fund**, existing resources and outreach efforts have been leveraged to recruit support from other private and public sector partners from throughout the state, including **RJR-Nabisco; The Harvey Foundation; Cannon Foundation; Daniels & Daniels, PA; Duke Energy; Fujitsu Network Communications, Inc.; GTE; SAS Institute; Shodor Foundation; SPRINT**; and nonprofit and government organizations.

MAST Academy's (www.mast.dade.k12.fl.us) outreach effort involves working with more than 40 middle schools across Dade County, Florida. **Royal Caribbean Cruise Line, Ltd.**, one of MAST's partners, has hosted hundreds of these middle school students at their corporate headquarters at the Port of Miami.

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As part of The McGraw-Hill Companies' advocacy of education, the Harold W. McGraw, Jr. Prize in Education was established in 1988 to mark the corporation's 100th anniversary and to honor its Chairman Emeritus for his lifelong commitment to education. This award salutes those who have had an unusually positive impact on others.

Each of this year's award winners has recognized the importance of establishing partnerships to achieve their desired goals in education and to maximize student performance. They all share a common devotion to innovative thinking, strong leadership, and accomplishment by example. We are honored to salute them.

**Paul A. Elsner and
Alfredo G. de los Santos Jr.**

Nowhere are the benefits of partnership more obvious than in the collaboration of Paul A. Elsner, Chancellor of Arizona's Maricopa Community College District, and Alfredo G. de los Santos Jr., Maricopa's Vice Chancellor for Student and Educational Development.

This is the team that brought the Maricopa Community College District from five colleges and 46,000 students to a district with ten colleges and 200,000 students, which now ranks among the nation's leaders in the use of computers and telecommunications.

By promoting connections between the district's two-year programs and those of local four-year institutions, Maricopa has significantly increased the number of students who seek and attain bachelor's degrees.

They have also helped to develop a seamless web to improve the relationship between the K-12 world and community colleges, contributing to their reputation as at least one of the country's most effective community-college leadership teams.

Elliot W. Eisner Elliot W. Eisner, widely considered one of the nation's leading scholars in arts education, has published much of the research identifying the benefits of education in the arts for all children. His work has brought education to the arts, and the arts to education. It has advanced our understanding of the contribution arts make to the development of those complex forms of thinking so critical today. It has helped schools find a place in their mission for the cultivation of the imagination and for the joys of art.

As public funding for arts education has been severely curtailed over the past twenty years, Elliot Eisner has sought to keep arts education alive, influencing university schools of education, gaining private and foundation funding for arts education initiatives, and continuing the important research into the connections between the arts and learning.

Arthur Greenberg As superintendent for District 25 in New York City, a very diverse urban school district, Arthur Greenberg has successfully sponsored a system-wide strategy to use the "expressive arts" as a key component in educating the district's 24,000 children and spurring them on to increasing academic achievement and personal development.

He has done so in the face of limited budgets by forming partnerships with local organizations to augment arts programs, and by working ceaselessly to find funding within the existing budget to put music and art teachers back in each of his district's schools. His belief in educating the "whole child" has helped a great many students to be successful in school and the community. Arthur Greenberg serves as an inspiration to both colleagues and students alike with his words and actions.

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PATENTS

WHAT'S NEXT— A PATENT FOR THE 401(K)?

A court decision protecting business methods could wreak havoc from E-commerce to banking

For companies that manage mutual funds, allocating gains, losses, and costs among a family of investment offerings has always been a huge headache. So it was a giant step forward when Boston-based Signature Financial Group Inc. in 1993 won a patent for a unique data-processing software program that cut down on the cost of crunching the numbers and even helped save on customers' taxes.

When State Street Bank & Trust Co. approached hometown competitor Signature to license the technology, it was rebuffed. So State Street challenged the patent. It cited longstanding legal precedent holding that "business methods," including methods that incorporate mathematical formulas, are not patentable. If Signature could legitimately claim ownership of this business method, State Street and other critics argued, then theoretically somebody could have claimed ownership of such common business tools as 401(k)s, double-entry accounting, and the mutual fund itself—and

who dared infringe on their monopoly a fortune.

The federal trial court in Massachusetts that originally heard the case agreed—holding that business methods are no more patentable than "laws of nature, physical phenomena, and abstract ideas." But on July 23, the prestigious D.C. Circuit Federal Court of Appeals overturned the decision, holding that a business method that uses a mathematical formula can be patented so long as it meets the three traditional criteria for legal protection: that it be new, useful, and not obvious to someone with knowledge in the field. In no uncertain terms, the court slammed the "ill-conceived"

legal precedent that had prevented the patenting of business methods. Noting that patent law is designed to give inventors ample incentive to innovate, the court noted that Congress intended the Patent Act "to extend to 'anything under the sun that is made by man.'"

FLOODED. The ruling has let loose a whirlwind of controversy. Critics fear the decision will give a few lucky patent holders huge windfall profits—meanwhile slowing the spread of valuable commercial innovations. A torrent of lawsuits seeking to capitalize on the *State Street* decision is likely to come next. That's because, in spite of decades-old case law prohibiting business-method patents, inventors have been flooding the Patent Office with applications in recent years betting on such a reversal.

And the government, which isn't the ultimate arbiter of a patent's enforceability, has been granting a growing number of method patents—most of

LOCKING UP THE RIGHTS

A major new court decision confirming a right to patent business methods will affect many types of business:

E-COMMERCE Net merchants fear recently awarded patents on secure transactions, push technology, scrolling tickers, and reverse auctions will stunt the development of E-commerce.

FINANCE With patents for complex money management products and services now legitimized, financial institutions could lock out competitors from new banking or insurance products.

HEALTH Specific methods for such medical basics as obtaining informed consent can now be owned, prompting fears that life-saving innovations won't be shared.



While Dodge Intrepid ES may turn a pretty face to the world, a closer look reveals an obvious depth of character. Its aluminum powerplant, for example, generates 225 horsepower from a mere 3.2 liters. That same efficiency of design translates to efficient operation as well. EPA estimated fuel economy numbers: 18 m.p.g. city, 28 m.p.g. highway.

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Legal Affairs

which involve software. Software patent awards exploded from about 1,300 in 1990 to 11,000 in 1997, according to Greg Aharonian, publisher of online newsletter *Patent News*, in large part due to the growth in methods patents. "These lame patents are going to cause more trouble than most people realize," he says. "It'll make the litigators and patent searcher happy, but I don't think it'll make anyone else happy."

Indeed, the *State Street* decision re-

**"These lame patents
are going to cause
more trouble than
most people realize,"
says one expert**

flects an important shift in legal thinking. Like copyright and trademark law, patent law balances the right of the general public to useful information with the right of inventors to benefit from their work. In part because of pressure from large companies with valuable intellectual-property portfolios, the tide has been shifting in favor of property owners.

While the new court decision will reverberate throughout Corporate America, the industry likely to be affected most is E-commerce, where business models are still developing. Recent E-commerce patents include that of CyberGold Inc., based in Berkeley, Calif., for a system of giving awards (with points) to people who click on an advertising message—a digital sister to frequent-flier miles. Netcentives Inc. of San Francisco received a similar patent for rewarding people who make purchases online.

GRUMPY COWBOYS. Net entrepreneur say that because these methods are common, they should not be eligible for patents. To A. Nathaniel Goldhaber, president of CyberGold, that's just sour grapes. "What they're really saying is 'Why didn't I think of it first?'" he says. "We're homesteading a new territory, and the cowboys will always be upset when the farmers move in and put up fences."

The financial value of Internet patents is open to question, however. Technology changes so quickly that some patents may be obsolete by the time they are awarded—usually two to three years after application. Going after tiny cyber-

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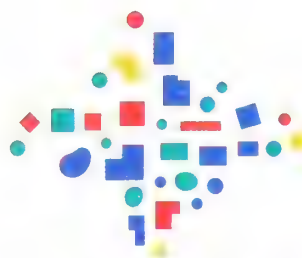
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Legal Affairs

ops that infringe on patents won't add much value to the patent holders, and big companies will likely have the resources either to prove the patents valid or cut a deal. But such patents generate publicity and inspire investors to cough up money.

Because of the massive flowering of new products and services in recent years, as well as innovative management techniques, the *State Street* decision is already having a strong impact on

The Supreme Court rarely rules on patent issues, but this one could be too important for it to ignore

financial-services, banking, and insurance industries. Several companies at own methods patents on potentially valuable consumer products have filed suits against infringers. College Savings Bank of Princeton (N.J.), for example, is suing the state of Florida for infringing its 1988 patent on prepaid tuition accounts, claiming that the state has earned a quarter of a billion dollars in profit from the bank's invention. Florida denies the charge, but in July a federal court rejected the state's attempt to dismiss the suit.

As a field in which innovative techniques are constantly surfacing, medicine is also likely to see a surge of new patents and litigation—not only in methods of treatment but also in the management of patient and claims processing. For example, AccessHealth Inc. in 1994 patented an automatic patient diagnosis and management system that it has already licensed to Humana Inc. in Louisville, Ky. But many doctors and health organizations fear greedy patent holders will slow down the diffusion of important medical breakthroughs.

The last hope for critics of the patent-anting trend is the U.S. Supreme Court, which rarely hears patent cases. But Harold Edgar, a law professor at Columbia University, thinks that may change. The issue of business-method patents is "too important to think the Supreme Court won't take up one of these cases," he says. Until then, the *State Street* decision is the law. And that means the rush to patent business methods will only grow more feverish.

By Edith Updike in New York

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SENATOR BOXER HAS REASONS FOR GOING EASY ON FONG

LECTIONS

WHAT THEY DON'T SAY ABOUT MATT FONG

Why nobody is talking about his Donorgate connection

It has been a fast ride for Matt Fong, a low-key California pol who is one of the Republican Party's best hopes for strengthening its majority in the Senate. As recently as 1995, Fong was laboring in obscurity as state treasurer. But he harbored big ambitions—and an appetite for campaign cash that could yet come back to haunt him as he tries to unseat Democratic incumbent Barbara Boxer.

Fong's troubles began in 1994. Saddened with a big debt from his treasurer's office, Fong began haunting the Sunset Boulevard offices of Indonesian businessman Ted Sioeng, a respected benefactor of Asian causes, who wrote Fong checks totaling \$10,000.

Since then, Sioeng has become a controversial figure. He is under investigation by the Justice Dept. as a possible conduit for Chinese government money in the 1996 Presidential election and fled the country after the scandal broke. Thus far, the probe has focused almost exclusively on Democrats.

In fact, Fong is the highest GOP of-

fice-holder to be dragged into Donorgate (though to his credit, he returned the \$50,000 as soon as questions arose about whether it came from overseas). And he is the only elected official who actually solicited money from the alleged "China connection."

However, such are the convoluted politics of scandal these days that Fong's campaign-finance problem is not even an issue in the Senate race. Boxer, so far, has not criticized Fong for two reasons: She has been a close ally of President Clinton, who has his own Donorgate problems. More important, she fears alienating California's Asian-Americans, who make up 5% of likely voters. And Fong's role has largely escaped notice in Washington, where fellow Republicans have kept him off the firing line.

His testimony before the House committee investigating Donorgate was postponed several times—most recently on June 5, three days after he won the California primary.

An Oct. 8 report by the House Government Reform & Oversight Committee finds no evidence that Fong knew

Fong, the GOP's rising star in California, could unseat the liberal Boxer

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Boxer started with a \$4 million war chest; Fong had a \$493,000 debt

Fong's contributions were tainted. Still, it raises questions about Fong's role. The committee found the \$50,000 all came from a Hong Kong company controlled by Sioeng, whom Fong knew well. He attended the weddings of two Sioeng's daughters and even gave a toast at one. And an earlier report by Democrats on the Senate Government Affairs Committee concluded that Fong "had every reason to suspect" that

Boxer's behavior in the Lewinsky scandal, though she may have had more reason than most Democrats for her reticence: Boxer's daughter is married to Hugh Rodham, Hillary Rodham Clinton's younger brother.

Boxer should be crushing Fong. She faced token primary opposition, while Fong had a grueling contest. She went into the general election with a \$4 million war chest; Fong began with a \$493,000



Fong was "not eligible to contribute to his campaign," a deposition, Fong says he pleaded to Sioeng that campaign-finance rules barred contributions from anyone who is not a legal resident. He says he assumed that Fong's contributions actually came from one of his children, all of whom are legal U.S. residents. Fong declined to discuss Fong's donation with BUSINESS WEEK. The House report also shows that Fong's wife benefited from a second \$50,000 donation by Sioeng's company at the National Policy Forum, a GOP tank. In July, 1995, Fong escorted Sioeng to a meeting with House Speaker Newt Gingrich in Washington where they discussed U.S.-China relations. Weeks later, Joseph R. Gaylord, Gingrich's top political adviser, sought help raising money for the NPF. Sioeng again was solicited, and his daughter wrote a \$50,000 check. Fong's wife, Paula, received \$6,500 as a commission from the NPF. Such commissions are not illegal, and Fong says he first found out about his wife's role in March, 1996, when he was preparing a financial disclosure form required of state officials. None of this has stopped Fong from attacking the character issue. He has attacked as hypocritical Boxer's initial si-

SIOENG (R) AND AL GORE at the infamous Buddhist temple fund-raiser

debt. Boxer gives a stirring stump speech that brings audiences to their feet. Fong speaks awkwardly from notes.

Still, an Oct. 9 Field Institute poll shows Fong leading Boxer 48% to 44% among likely voters. According to the poll, Boxer, a brassy and abrasive liberal, is viewed negatively by a majority of voters. Boxer has tried to fight back by portraying the moderate Fong as an extremist who opposes gun control, environmental programs, and late-term abortions. It hasn't worked. "It's very difficult to convince anybody who's had exposure to Matt Fong that he's an extremist," says Dan Schnur, a GOP consultant. "He's such a cerebral, non-threatening kind of person."

While Boxer agonizes about making an issue of Fong's Donorgate problem, Republicans are going all out for Fong, whom they hail as the new Upset Kid. They have imported such GOP luminaries as former Vice-President Dan Quayle and New York City Mayor Rudy Giuliani to stump for Fong. If it works, Fong will wake up on Nov. 4 as a new member of the U.S. Senate—and his messy fund-raising will be politics past.

By Paula Dwyer, with Richard S. Dunham, in Washington, and Larry Armstrong in Los Angeles



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BRANDS

THEN CAME BRANSON

He's rich, he's flamboyant, and he's full of ideas for new ventures. But is he flying too close to the sun?

On a sultry September afternoon, a weary Richard Branson climbs aboard a Virgin Atlantic 747. Branson, founder and chairman of London-based Virgin Group, has just watched the jumbo jet unload 33 tons of relief equipment on hurricane-swept Antigua. He has also just come through a four-day publicity blitz that included a celebrity cricket match in Barbados and a catamaran cruise in St. Lucia to promote his airline's new Caribbean service. When the aftermath of Hurricane Georges forced him to cancel the Antigua leg of the V.I.P. junket, he quickly organized the relief effort, spotting a chance to engender local goodwill—and publicity. But ever the showman, Branson can't resist a final flourish. In the cool, darkened cabin of the nearly empty jumbo jet, he shakes a journalist's hand on a promise: to meet again on Virgin's inaugural flight into outer space.

Starship Virgin? Branson's dreams for his brand seem boundless. Since his counterculture days in the early '70s, when he

RICHARD BRANSON

BORN 1950, the son of an English barrister and his former airline hostess wife.

EDUCATION Beaten at Scitcliffe Preparatory School for poor grades. Skipped college; instead moved to swinging London in the late 1960s to work on a magazine he co-founded called *Student*.



lived on a houseboat in London, Europe's best-known entrepreneur has built an empire of some 200 companies with combined yearly revenues of an estimated \$4 billion. His group spans three continents and includes planes, trains, financial services, music stores, cinemas, and cola. Restless and driven, Branson, 48 years old and, according to London's *Sunday Times*, worth an estimated \$1.7 billion, is a celebrity in Britain who rubs shoulders with royalty and pop stars alike. He's also an energetic self-promoter. It's no coincidence that *Losing My Virginity*, Branson's new autobiography, is hitting U.S. bookstores this month just as he's expanding his airline, building new megastores, and rolling out his cola in the U.S. "I want Virgin to be as well known around the world as Coca-Cola," he says.

"SO MANY PRODUCTS." With ambition like these, some people wonder whether Branson is in outer space already. The flamboyant and media-savvy entrepreneur, who once promoted a new venture by donning a wedding gown for photographers, has helped make Virgin a recognized name with strong associations. But with the name now attached to dozens of unrelated ventures, marketing experts are warning that Branson risks diluting his brand strength. "Overstretching ends up in only one way snapping," says Jeremy Bullmore, an ad industry veteran and an outside director for advertising giant WPP Group PLC. "I can't think of a company that has put its brand on so many products."

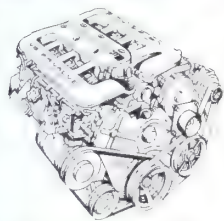
Then there's the question of Branson himself and his ability to manage this chaotic empire. Few of Virgin's many businesses make big profits, and two of the biggest cash generators, Virgin Atlantic Airways and

FIRST HIT Mike Oldfield's *Tubular Bells*, released in 1973 by Branson's Virgin Records.

FAMILY Marriage to American Kristen Tomassi ends after wife-swapping episode. Marries Joan Templeman in 1989 after living together for a dozen years and having two children, Holly and Sam, with her.

DATA LOSING MY VIRGINITY VIRGIN KING, BUSINESS WEEK

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an 18-month-old British railroad venture, are problematic. Analysts think the cyclical airline industry may be poised for another down cycle. Virgin Rail Group Ltd. turns a profit only with the help of government subsidies that will phase out by 2010. At a time when other companies are preparing for a global economic downturn, Branson is crisscrossing the U.S. on a book tour and preparing for another attempt at circumnavigating the globe in a hot-air balloon in December.

Branson knows firsthand the dangers of stretching his business too far. Virgin made its name as a record company in the 1970s representing such groups as the Sex Pistols. But during the recession of the early 1990s, Branson was forced by his bankers to sell the record business to raise cash for his struggling startup, Virgin Atlantic. Branson still mourns the loss of the music business. "I had to sell a company I loved," he says. Branson insists he'll never put himself at the mercy of bank lenders again.

Instead, he has embarked on a strategy he calls "branded venture capital" that has allowed him to launch a hodgepodge of businesses with minimal investment. Essentially, Branson manages the venture and puts up the Virgin name, usually in exchange for a controlling interest, while his wealthy partners put up most of the cash. In financial services, he has teamed up with insurer Australian Mutual Provident and Royal Bank of Scotland PLC to sell investment products in Britain. In trains, he has hitched up with Stagecoach Holdings PLC, which operates double-decker buses in London. And until recently, his cola venture was backed by Cott Corp., the Canadian private-label soda maker. "Not only does he come to us with great ideas, but he's willing to put in some of his own money to back them," says Randall L. Shure, managing director of BT Capital Partners Europe, an early partner in the rail venture and a current investor in Virgin Entertainment. When Stagecoach bought out its stake, BT nearly tripled its investment in less than two years.

STRONG TEAM. The strategy has helped Branson expand his brand around the world. But teaming up with an equity partner carries its own risks, mainly that of having to buy out partners that are ready to move on. In the past several years, Branson has bought back

Virgin Key Businesses

COMPANY	1998	CHANGE
VIRGIN TRAVEL GROUP LTD.* (includes Virgin Atlantic and Virgin Holidays) *For the year ended Apr. 30, 1998	Revenues \$1.6 billion	+20%
	Pretax profits \$151 million	+38%
VIRGIN ENTERTAINMENT* (includes Megastore and Virgin Cinema) *For the year ended Jan. 31, 1998	Revenues \$1.3 billion	+10%
	Pretax profits \$81 million	+23%
VIRGIN RAIL* (includes Cross Country and West Coast) *For 11-month period ending Feb. 28, 1998, after takeover	Revenues \$671 million	+2%
	Pretax profits \$22.9 million	NA

DATA: COMPANIES HOUSE, VIRGIN GROUP LTD.

stakes from Cott, Blockbuster Entertainment, and British retailer W.H. Smith, for a total cost of \$270 million. And history shows that the Virgin name is no guarantee of success. Notable non-starters include ventures in vodka, computers, and a magazine.

Branson's toothy grin and corny publicity stunts have led some to dub him the P.T. Barnum of British business. But behind the scenes, he has assembled an executive team with solid Establishment credentials. A year ago, Branson brought in Gordon McCallum, a former McKinsey & Co. consultant, as group strategy director to impose some discipline on how the Virgin brand is used. Stephen Murphy, the group's finance chief, is ex-Mars, Unilever, and Quaker Oats. And behind his playful image, Branson himself is a tough competitor and negotiator.

While most brand stewards use extreme caution before extending a val-

ued name to a new product, Branson takes a different tack. He says the Virgin brand is irreverent, eager to take on the Establishment, and dedicated to service. He believes that the occasional failure doesn't hurt, as long as Virgin is perceived to be fighting the good fight. Indeed, the one thread that runs through the tangle of Branson's business interests is his preference for entering industries where customers have few choices. "We like to use the brand to take on some very large companies that we believe exert too much power," he says.

Yet for a people's champion, Branson has created a complex and opaque empire. Most of his companies are private and domiciled in tax havens such as the

Channel Islands. Because he's constantly shifting companies around and forging and discarding business partnerships, it's difficult to gauge Virgin's performance. Branson says he has built up a \$420 million cash pile and that his companies produce a quarter-billion more in cash flow each year with scant debt. One reason its disparate ventures haven't hopelessly confused the Virgin image—drained its finances—is that Branson doesn't mind starting small. Virgin's new bridal and fashion ventures, for example, are just too tiny to matter much to the empire's financial well-being. Even from retrenching, Branson says he's considering new ventures such as credit cards, phones, and health clubs.

"DOWN, RICHARD." No wonder it's a standing joke among Branson's top aides that they're paid to curb some of the boss's wilder schemes. "Richard comes up with ideas, and we say: 'Down, Richard,' jokes Virgin Atlantic CEO Steve Ridgway. Yet Virgin Atlantic was once widely predicted to follow Freddy Laker's airline as another doomed transatlantic startup. Instead, in its 15-year history, Virgin has shaken up the industry and stolen share from British Airways PLC. Rather than try to compete just on price, Virgin has offered better creature comforts—seat-back videos, upgraded business class, onboard massages and massages, and curbside check-in. The airline earned \$129 million in sales of \$1.4 billion for the year that ended on Apr. 30, and it threw off nearly \$340 million in cash, making it one of the healthiest airlines in the world, according to Michael K. Lowry, publisher of industry newsletter *AirWatch Report*. Now, Branson is lobbying the U.S. Congress to change the law barring foreign

BRANSON'S BUGABOOS

COLA COMPETITORS Virgin Cola has made little headway against global giants Coca-Cola and Pepsi.

TRAIN TRIALS Service on newly acquired British train lines is shoddy. Dubbed "a national disgrace" by officials.

AIRLINE GROUNDED U.S. laws have blocked Branson's quest to fly the domestic skies.

DANGEROUS HOBBIES Branson already crashed a hot-air balloon in Algeria in 1997 while attempting to circle the globe. He plans another try in December.

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carriers from owning more than 25% of a U.S. airline. Industry experts say he has little chance of success, and some believe his real goal is to prevent approval for the planned alliance between British Air and American Airlines Inc.

Even more quixotic is Branson's push to launch Virgin Cola in Europe and the U.S. The effort puts him squarely in competition with Coca-Cola Co. and PepsiCo Inc., two of the most powerful brands in the world. Branson calls his rivals "cola duopolists." Although he rode a vintage World War II tank through New York's Times Square last May to launch his soda, the brand's market share remains negligible—and skeptics abound. "It would be easier to make a snowman in July in Florida than to take on Coke and Pepsi," says John Sicher, publisher of trade journal *Beverage Digest*. For starters, Branson has been without a bottling-and-distribution network since buying out Cott last year after the two companies disagreed on strategy. "[Branson] wanted more to take on Coke and Pepsi, and that really wasn't what we had in mind," says

Fraser D. Latta, vice-chairman at Cott. Although the brand's quirky television commercials inviting viewers to come on the air and rant about whatever's on their minds are still running, Virgin's investment is minimal and Branson has little riding on the venture except his prestige.

NEW TIMES. Two of Branson's British ventures seem almost as unlikely as cola. Virgin Direct sells investment products and Virgin Rail operates two lines bought during British Rail's privatization amid promises that Branson could make the trains finally run on time. Both, says Branson, offer a chance for Virgin to shake up stodgy industries in the name of giving the customer a better deal. Although some of Virgin Direct's innovative

BARNUM WOULD BE PROUD



BATTLE CRY: RIDING A TANK IN TIMES SQUARE AT VIRGIN COLA LAUNCH

QUEEN FOR A DAY: WITH CROSS-DRESSING M.C. AT A NEW YORK MEGASTORE



WHATEVER IT TAKES: WEARING A GOWN TO GIVE VIRGIN BRIDAL A BOOST

products have been copied, this is a long-term proposition at best. The three-year-old venture has lost more than \$33 million since it was launched, and CEO Rowan Gormley doesn't predict a profit until 2000 at the earliest. The rail business makes money, thanks to government subsidies, but improving service has been harder than Branson anticipated. As a result, the business has been plagued by embarrassing missteps and bad publicity. One recent mishap led Deputy Prime Minister John Prescott to declare the privatized system "a national disgrace" and to lash out that "when it comes to railways, I'm no Virgin."

Virgin Entertainment, which includes 148 book, music, and video megastores worldwide and a British movie-theater

business, proved obvious fit with the Virgin brand. But though it makes money, it, too, has struggled. Last year, it closed six stores in Europe, and already Branson has had to buy out two partners. Blockbuster wanted out after it was acquired by Viacom in 1994. W.F. Smith put its stake up for sale last fall, when it decided to focus on its bookselling business. Simon Burke, head of Entertainment, downplayed the problems. "Times are different now, and we have very strong cash flow," he says. "We are well able to finance our own expansion." He says the business will earn about \$100 million this year on sales of \$1.4 billion. Virgin plans to add some 20 stores worldwide next year, including nine in the U.S.

Branson's close identification with the Virgin brand has imbued it with a great sense of personality—indeed, it's crucial to the Virgin brand that Branson continue to be seen as the hero. And despite the rail problems, he still lives in Britain. For the second year in a row, Branson was named the country's best business leader in a survey of senior managers by KPMG

Management Consultants, and his name is regularly floated as a possible Mayor of London.

Of course that enormous personal appeal poses a difficult question for the group. What are the prospects for Virgin if something should happen to Richard Branson? At the least, such a loss would leave Virgin without its ringmaster. Branson, of course, emphasizes the positive: "When artists die, their products sell for twice or three times as much. Hopefully, the same thing will happen to Virgin products if I go." As P.T. Barnum might have said: "On with the show."

By Julia Flynn in Antigua, Wendy Zellner in Dallas, Larry Light in New York, and Joseph Weber in Toronto

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A \$2.5 Trillion Market You Hardly Know

Securitization exploded as a way to package and sell debt to investors. Now the market is in a funk

It seems to be the perfect security, the magic bullet of finance. From a package of the riskiest, scuzziest, least liquid loans, you can create a special kind of bond rated AAA. In more than a decade, there has hardly ever been a loss of principal and relatively few rating downgrades. Over the years, the bond has fared much better than traditional corporate debt. And there are \$2.5 trillion of these bonds outstanding.

Welcome to the arcane but crucial world of securitization, as the process of creating these bonds is called. The bonds themselves are popularly known as asset-backed securities (ABS) or mortgage-backed securities (MBS). That's because they are collateralized by money flows from the borrowers. Securitization is ubiquitous: If you have a mortgage, credit card, or auto loan, you are likely part of it, whether you know it or not. Securitization's main virtue is that it links the home buyer or the credit-card borrower to the vast resources of the global capital markets.

But despite its gargantuan size, it's a largely invisible market. Asset-based securities don't trade on any exchanges. The ABS and MBS markets, exclusively

institutional, release little information and are never covered on the evening news. But there's no doubting the significance of the market. According to Leon T. Kendall, a finance professor at Northwestern University: "Securitization is one of the most important and abiding innovations to emerge in the financial markets since the 1930s."

What the ABS and MBS markets do best is make marketable loans that otherwise would be unsalable: everything from aircraft leases to revenues from old Italian films to tax liens in New York. "We're working on securitizing TV syndication, film libraries, and royalties. The possibilities are endless," says investment banker David Pullman, managing director of The Pullman Group in New York.

Yet after a decade of explosive, unblemished growth, signs of trouble have been cropping up in what has been mostly a AAA world. The market has tended toward excess—too much liquidity in good times, too little in bad.

The current worldwide liquidity crunch is beginning to affect the market, which was reflected in an ABS conference in Bermuda earlier in October. The mood

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PACKAGED DEBT OVERSEAS

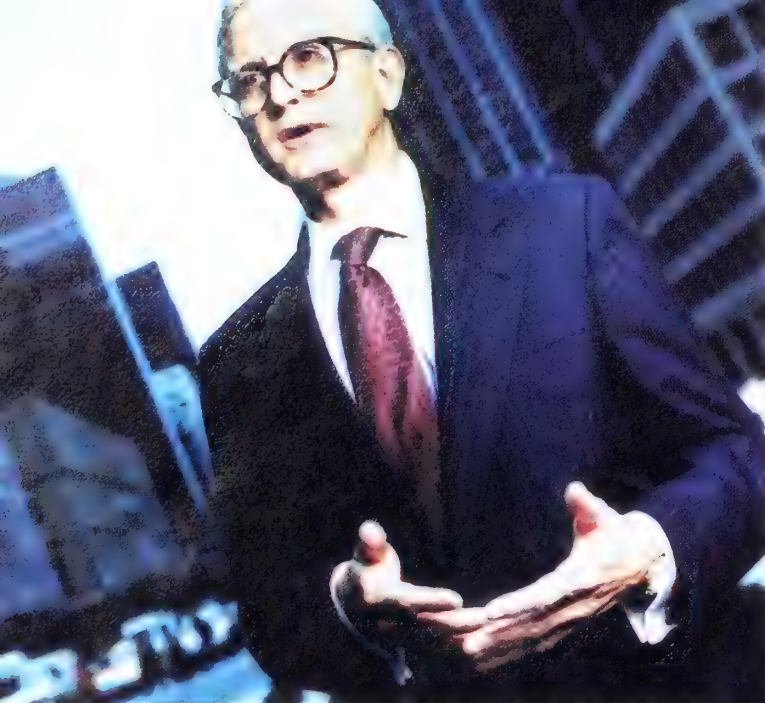
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“We had a major financial event and the securitization market didn’t shut down”

—JAMES MOORE, CEO, ContiFinancial

ease with which companies were able to raise cash—and still can—has led to ruinous competition. Citiscape Financial Corp. of Elmsford, N.Y., was the latest subprime lender to go bust when it filed for bankruptcy protection on Oct. 7.

■ The \$200 billion market for securitized bonds backed by commercial mortgages—CMBS—is in disarray. Citi Mae Inc., the biggest buyer of low-rated bonds, filed for Chapter 11 on Oct. 5. Conditions have been devastating for investment banks like Nomura Securities Co. that originate commercial mortgages in hopes of securitizing them. By the time the banks were ready to use the mortgages to back paper, the value of the loans had dropped and the planned bond deals were no longer profitable. As a result, banks delayed doing deals and stopped new lending for commercial real estate. “We are now

among the normally upbeat attendees was one of “a kind of general malaise,” says Brian Clarkson, managing director of Moody’s Investors Service. John Wilson, managing director of Prudential Investments, remembers it was only a year ago when “a banker calls us up and says, ‘We have this deal in the

market. Here’s a two-page description.... We need the bid in the next half hour.’”

Special Report

CORPORATE FINANCE

The bulk of the securitization business world is shrugging off the bad news. Business at Fannie Mae, Freddie Mac, and Ginnie Mae, the huge government-sponsored enterprises that finance housing, which account for 88% of the MBS market, have been largely unaffected. The three agencies account for more than \$1.9 trillion of the securitized paper outstanding.

WIDE SPREAD. But the ABS market has been showing disquieting vulnerability. Spreads in deals are widening rapidly: While AAA deals sold at only 35 basis points above Treasury bonds just last year, now the gap is much larger: 90 basis points. Another gauge is downgrades on deal tranches, securities that have been cut in pieces, by rating agencies. Until this year, less than 1% of the thousands of tranches were downgraded. This year, 3.3% of the deals involved downgrades. That’s a small percentage, but another sign that things are not well.

Two major sectors of the ABS market in particular are feeling lots of pain:

■ A slew of subprime lenders who went public at lofty multiples crashed and burned this past year. The reason: The

paying the price for having public markets finance real estate,” says E.J. Burke, president of National Realty Funding. “Markets move quickly. They may be generally efficient, but they can be irrational at times.”

Efficient markets were exactly what securitization was designed to promote. In the 1970s, fears that savings and loans wouldn’t be able to finance a growing demand for housing led to the creation of the first mortgage-backed securities. When S&Ls went bust in the ’80s, Resolution Trust Corp. turned to securitization to clear the books of beleaguered banks.

In a sense, though, the principles behind securitization were nothing new. At Citicorp, for instance, the process began as an outgrowth of a traditional business known as “factoring,” in which manufacturers raise cash by selling receivables, says Alvin G. Hageman, managing director at Citi-

corp Securities Inc. That led Citi to begin thinking in the 1980s about buying other assets and trading them. “It was a garment-center business,” Hageman says. “We said: ‘How can we take the business up-market?’”

In the ’90s, the practitioners of securitization took the process upmarket—and down. The biggest asset-backed markets have been consumer finance, mostly credit-card and home-equity loans. They grew from \$50 billion in 1990 to \$184 billion last year. Moody’s Clarkson estimates this year’s total will reach \$220 billion.

As investors scooped up paper, lenders sprung up in droves to give them more. In the mid-1990s, dozens of companies were created to make subprime home-equity and auto loans and securitize them. “The old wisdom that you had to be

THE BOOM IN PACKAGED DEBT

Bundling loans and mortgages to create salable securities has revolutionized finance. But portions of the market may be in serious trouble.

THE GOOD NEWS

- ▶ Illiquid assets can be made salable
- ▶ Virtually any payment flow can be securitized
- ▶ Securities can be designed to provide any risk level
- ▶ The most distasteful asset can achieve AAA rating

THE BAD NEWS

- ▶ Issuers of auto and home-equity loans have recently collapsed
- ▶ Securitization can promote excess credit creation, leading to busts
- ▶ Assumptions of consumer behavior may go awry, damaging expected cash flows
- ▶ Liquidity may be illusory during sharp contractions

DATA BUSINESS WEEK

ANY DECENT
PLASTIC SURGEON
CAN MAKE A PERSON
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A WORLD OF ENERGY.

“ Investors prefer a stronger name . . . to a weaker credit issuer. There's a flight to quality ”

—BETH STARR, Lehman Brothers

of mid- to high-investment-grade quality to compete in the finance business was turned on its head by securitization,” says Scott J. Ulm, managing director of Credit Suisse First Boston.

At the same time, new asset classes emerged, some with little or no history on which to base estimates of expected payments. Perhaps the most notable example was the high-loan-to-value (HLTV) products that enabled consumers to borrow up to 125% of the value of their homes. Billions of dollars in paper backed by such debts has been sold.

FIERCE COMPETITION. But the flood of money into the subprime sector led to problems. Fierce rivalry for borrowers resulted in faster-than-expected repayments of subprime loans. And that reduced the profits for companies making loans.

The issuers' problems stem from the structure of asset-backed loans. The slicing and dicing of these securities entitles some investors to get paid before others. At the top of the

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feeding chain, ratings are AAA, yields are low, and buyers include pension funds and

insurers. As you move down, ratings fall, returns rise, and hedge funds get interested. The issuer usually keeps the last piece of the pie—and makes its profits based on how much of that last piece materializes.

However, as prepayments pick up, that last piece keeps getting smaller. Across the industry, companies had to write down profits, and share prices fell into the pennies. “The industry is getting annihilated,” says Steven Eisman, analyst at CIBC Oppenheimer Corp.

Moreover, as the markets soured, lower-rated tranches in these deals have lost value, particularly in already-controversial assets like HLTVs. “There isn't a market for any of those,” says Michael Hoey, portfolio manager at Dreyfus Investments. “It's almost like buying a lottery ticket.”

Now, investors are becoming increasingly worried about issuers failing. Issuers typically collect the loans, and investors fear interruptions in servicing could prove dangerous. “Investors prefer a stronger name . . . to a weaker credit issuer,” says Beth Starr, a Lehman Brothers Inc. research manager. “There's a flight to quality.”

For critics such as economist Henry Kaufman, these market upsets underscore a risk—“the illusion of liquidity.” They worry securitization is based on a false premise—that because you can make a loan tradable today, you can

trade it tomorrow. “There is this feeling that I can now buy a marginal asset and as long as I can trade it off, my risk isn't so great,” says Kaufman, a former Salomon Brothers Inc. economist who now runs his own New York consulting firm.

Practitioners, however, argue that liquidity hasn't dried up. Michael J. Malter, managing director of Chase Securities Inc., notes that nearly \$25 billion in asset-backed securities was issued in September—compared with about \$12 billion in high-grade corporate bonds. “In the context of the most stressed fixed-income markets we have seen, we have this shockproof durability of the asset-backed market,” he says.

ContiFinancial Corp. offers a case in point. Its stock tumbled from from \$38.5625 to \$2.9375 in October. But during that fall, on Sept. 25, Conti issued a \$2.1 billion asset-backed bond.

“We had a major financial event and the securitization market didn't shut down,” says Conti CEO James E. Moore.

However, consumers may wind up paying the price. Securitization links borrowers to the markets. The Fed is lowering rates, but with spreads widening on asset-backed companies like Conti are raising theirs. “The capital markets are very clearly driving the rate to the customer,” says Moore. “We have been able to pass on our capital market cost to the consumer.”

It's a change. For years, as rates fell, securitization made credit cheaper and more available. “We have had great times with securitization,” says Northwestern's Kendall. The question is whether those times have ended.

By Gary Silverman and Debra Sparks in New York with Andrew Osterland in Chicago



“ We're working on securitizing TV syndication, film libraries, and royalties. The possibilities are endless ”

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Bad Loans Made Good

Securitization is a kind of alchemy. It transforms often risky loans into attractive packages for big investors. Here's how

Lousy credit record? Having trouble paying your bills? No problem! We've got just what you need. What's the magic bullet? The home-equity loan.

Once it was a small sliver in the vast array of ways to lend money to needy consumers because very few people were willing to take the credit risk. Today, it is perhaps the biggest and most lucrative securitized loan product, dwarfing credit-card and auto debt. Indeed, many home-equity loans are taken out to pay off higher-interest credit-card debt. In 1997, \$68 billion in home-equity loans was issued. That's quite a jump from five years ago when only \$6.2 billion in home-equity loans were securitized.

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In recent weeks, the pervasive euphoria in the home-equity business has turned sour, as the riskiest securities have become almost impossible to sell. But the securitization business is still a lucrative money machine. The process is a kind of alchemy: It turns the riskiest individual loans to a household into a relatively safe investment product. People and firms who perform the alchemy have long-standing working relationships with one another. Here's how a typical deal works:

Steve Whitford initiates the process. He is a branch manager at Old Kent Mortgage Co., a mortgage banker in Phoenix, Ariz. Old Kent, the 18th-largest mortgage banker in the country, generates more than \$11 billion of mortgages—most of which is of the highest credit quality. It recently started targeting so-called subprime, or “b and c,” mortgage customers who have spotty credit records. The

subprime market offers higher profit margins, and Whitford feels like he can help a broader range of people. To locate new customers, he combs through lists of homeowners with high-interest mortgages or gets local banks or collection agencies to send him their referrals.

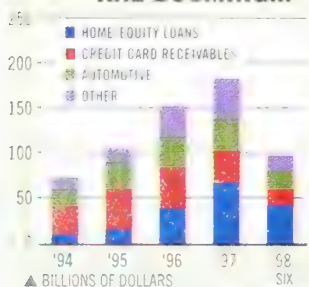
FINANCIAL HICCUPS. Before offering a subprime mortgage, Whitford delves into the customer's credit history. “There are two different [issues],” says Whitford: “one-time events that happen like a divorce or loss of employment or medical problems that may cause a [financial] hiccup.... The other is the chronic b and c customer that since age 18 has always been slow to pay.” Both types could qualify for a loan.

When Whitford is satisfied, the mortgage is sent to Old Kent's Grand Rapids (Mich.) headquarters for final approval. Once a new mortgage is signed off on, it stays on Old Kent's books for at most 60 days before it is sold to an investor.

Old Kent sells mortgages to a variety of financial institutions but often works with Ocwen Financial Services, which buys mortgages and performs securitizations. At Ocwen's West Palm Beach (Fla.) headquarters, Jeffrey W. Lucas supervises the deluge of mortgages acquired from roughly 1,000 independent regional brokers and bankers across the country. “When we buy from Old Kent,” says Lucas, “they typically have held it for at least 24 hours. This way we can ensure they actually own the loan.” Before purchasing it, however, Ocwen reviews the paperwork and makes sure the loan fits Ocwen's risk guidelines. If it passes muster, the loan is bought.

The mortgage, like a piece of machinery on a conveyor belt, works its way toward Ocwen's securitization depart-

ASSET-BACKED DEALS ARE BOOMING...

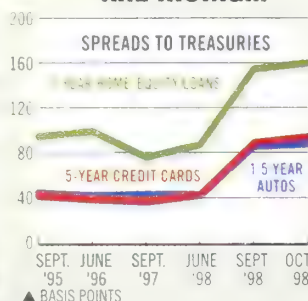


DATA: LEHMAN BROTHERS INC., MOODY'S INVESTORS SERVICE

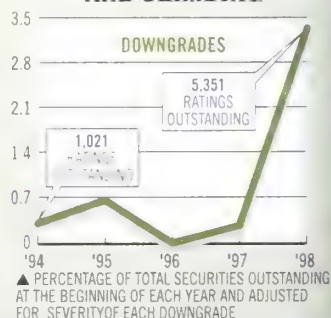
...AND SO ARE MORTGAGE-BACKS...



...BUT SPREADS ARE RISING...



...AND DOWNGRADES ARE CLIMBING



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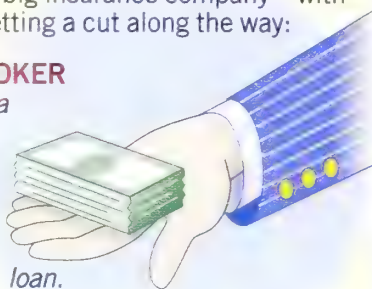
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ANATOMY OF A DEAL

Securitization is a money machine. Here's how a household's loan payments end up as the interest on a bond received by a big insurance company—with lots of people getting a cut along the way:

1 MORTGAGE BROKER

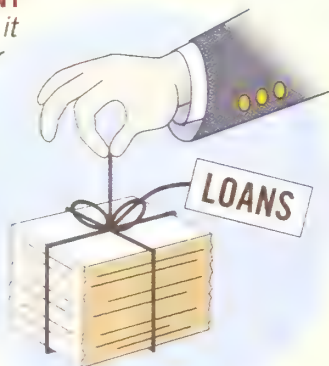
1 offers consumer a home-equity loan, typically to refinance credit-card debt. Broker checks consumer's credit history and approves loan.



2 FINANCE COMPANY

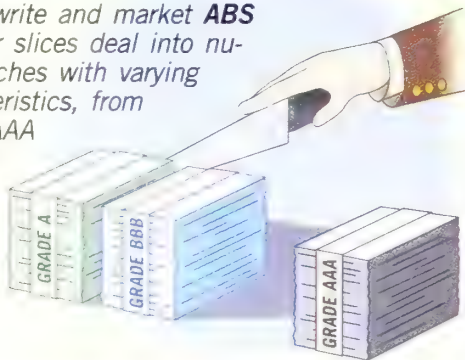
2 buys loan, bundles it with thousands of other home-equity loans worth \$100 million or more, to create a liquid asset-backed security, or **ABS**.

Finance company also gets rating agency opinion, insurance, and a trustee to oversee loans.



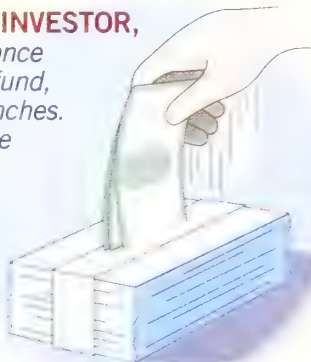
3 INVESTMENT BANKER

3 is engaged by finance company to underwrite and market **ABS** deal. Banker slices deal into numerous tranches with varying risk characteristics, from high-grade **AAA** to low-grade **BBB**.



4 INSTITUTIONAL INVESTOR,

4 typically an insurance company or pension fund, buys some of the tranches. Returns to investor are funded by interest payments paid by consumer.



ment, where Richard Delgado, vice-president of Ocwen's capital markets, takes over. Usually every three months, he packages between \$100 million to \$400 million worth of different mortgages for sale.

Delgado's department, meanwhile, hammers out the details. Lawyers representing the various parties arrive by the boatloads. Accountants hired by the investment bankers pore over the loans yet again in what will take two weeks to two months before going public. During that time, analysts from rating agencies determine how well the loans will perform. "At any given point in time, there can be 20 people on a conference call," says Delgado.

BUMPIER MARKET. Nearly all deals entail what is known as "credit enhancement" to protect the investor from even the riskiest loans. The enhancement can consist of such items as insurance and excess collateralization. Then, a trust is created to buy the mortgages and issue what are called asset-backed securities, because the mortgages are collateralized by mortgage payments. The trust is also in charge of the cash flows, administered by an appointed trustee.

Next is selling the securities. That is performed by an underwriter, usually an investment banking firm. Over the past few years Ocwen has worked with Lehman Brothers Inc., one of the leading firms in the asset-backed securities business. Says Brad Andres, vice-president of Lehman's asset-backed finance group, "There's a slightly different profile from one portfolio to the next, even from the same issuer because each can include a wide variety of loans from borrowers with different credit backgrounds."

While the rating agencies and insurance companies are out to protect future investors or themselves, it is the investment banker's responsibility to make the deal as lucrative for the issuer as possible. That means getting the best price on bond insurance and the least costly credit enhancement.

Lehman then slices the pool of mortgages into a dozen or more securities that are called tranches, representing different levels of risk and duration. Then Lehman traders hit the phones, calling potential buyers of the paper who get a feel for investors' appetite. Soon the securitization is priced and sold into the marketplace.

One institutional investor who sometimes buys Lehman's asset-backed issues is Steven M. Thompson, managing director at Prudential Investments in Newark, N.J. One of the first areas he investigates is whether the finance company's collection division is up to snuff, since subprime borrowers tend to need lots of monitoring in paying their bills.

"The lower-rated, riskier tranches in deals like this used to be fairly easy to sell," says Thompson. "But as the market has gotten bumpier and choppier through the summer, now it's pretty difficult to find investors."

Tompson, in fact, has soured somewhat on the subprime world. "Whether it is the home-equity or auto market, all of these guys have gone further down the credit spectrum without getting paid any more for doing it. There's been so much competition. Companies refinancing each other, cannibalizing each other's clients... the liquidity crisis has exacerbated some of this." Yet Thompson adds: "We are still buying. But we're careful in what we're buying."

By Debra Sparks in New York

All deals have insurance and extra collateral to protect investors from losses

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WEB

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An Exit Plan For Japan?

From Europe to Asia, the bundling of bad loans into marketable securities has slowed to a crawl. But Tokyo may be a ripe market

It seems like an elegant solution: Japan's crippled banking system is saddled with \$1 trillion-plus in dud loans. And Tokyo officialdom is about to embark on a very pricey public bailout: \$510 billion. But what if the lion's share of problem loans could be bundled into marketable securities and sold off to global investors? Banks would finally unburden their books of the stuff, replenishing their anemic capital bases.

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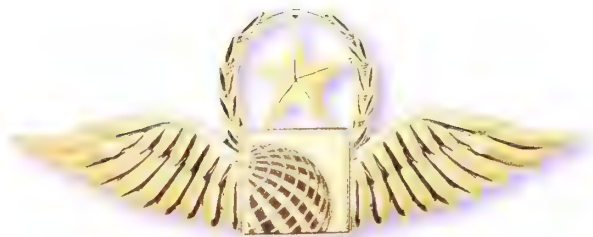
CORPORATE FINANCE

Then they could get into the business of lending again, ending a debilitating credit crunch that has pushed Japan into its most severe recession since World War II.

That, at least, is the pitch from investment banks salivating over the prospect of picking up distressed real estate for a song, then pulling down big fees and profits by selling off asset-backed investments. For several years, J. P. Morgan,

Goldman Sachs, and Bankers Trust have been prodding Japan to give it a try. After all, Japan will securitize more than \$2 billion worth of healthier loans this year. That shows quite an appetite compared with last year's sales of less than \$17 billion, according to Moody's Investors Service. "The largest portion of securitizations comes from commercial loans to Japanese corporations. Those are performing loans and a lot of good loans," says Noel E. Kirnon, a managing director of Moody's in New York. But when it comes to Japan's distressed properties, no one seems to want to pick up the tab. "We're not seeing a third party emerge that's confident in the underlying assets of these loans," adds Kirnon.

"NO HISTORY." The malaise pervades not only Japan but the rest of Asia and even Europe: Deals are few and far between. But Japan is clearly the biggest problem. Milton Ezrati, who is chief investment officer for Nomura Asset Management, thinks that if Japanese banks refashioned even a portion of their most troublesome commercial mortgages into salable se-



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curities, it would be enough to support a \$100 billion market in Japan.

It's an enticing vision. But the legal, tax, and cultural forces arrayed against a speedy sell-off of Japan's bad loans and their underlying collateral are considerable. Although the U.S. has had a mature securitization market for decades, "there is just no history here like in the U.S.," says Ken Curtis, a managing director at Secured Capital Co.

Successful Japanese deals involve prime properties. Long Term Credit Bank of Japan Ltd. and Nippon Credit Bank Ltd. sold most of their overseas loan portfolios to shore up capital-adequacy ratios. Foreign investment banks have been ready buyers. Goldman, Sachs & Co. raised eyebrows by bagging Meiji-era Yamato Seimei building in central Tokyo this summer and selling off the rental-income rights to global investors in a deal worth about \$550 million.

"It's slow going, but it's moving forward," says Jack Rodman, a managing director for Asian real estate at E&Y Kenneth Leventhal in Los Angeles. "There's no doubt that investors who are buying portfolios of nonperforming loans in Japan are looking to securitization as an exit strat-

“There's no doubt that investors who are buying portfolios of nonperforming loans in Japan are looking to securitization as an exit strategy” — JACK RODMAN, E&Y Kenneth Leventhal

egy.” But Rodman says bonds backed by commercial mortgages are at least a year away. Foreign investors in Japanese properties, he adds, are also waiting for the formation of real estate investment trusts (REITs) in Japan before bundling their properties for sale. “The REIT market in Japan is progressing,” he says. “The people I am advising are planning to warehouse the better assets” until that time.

Yet repackaging low-risk assets such as credit cards, income streams from premier office towers, and loan portfolios to rock-solid foreign

companies is one thing. Unloading Japan's most wretched commercial real estate mortgages, let alone, say, Indonesian corporate paper, is quite another. Property prices have fallen 80% since 1992. And some ill-advised real estate projects are yielding such meager flows of cash that it will be difficult to attract much interest. “The quality of assets here is much worse than the U.S. experience” with the thrifts, says Susumu Kato, an economist at Barclays Capital in Tokyo.

Then there's the reluctance of many banks to sell their loans. There's the hope, however fanciful, that Japan's real es-

tate market will come roaring back sometime down the road.

Deals in the rest of Asia have halted because of reduced investor appetite. Says Michael Malter, a managing director and group head for global asset-backed securities at Chase Securities Inc.: “[International business] has really dried up.”

In Europe, securitizations also have slowed to a crawl. Most major European banks have big loan-securitization programs planned or under way—Credit Suisse, Deutsche Bank, Dresdner Bank. Last year, total securitization issuance in



Europe was \$64 billion, with Britain and France leading. However, after a big first half in 1998, activity seems to be largely on hold. “Markets are too turbulent to be selling much of this kind of stuff,”

says Stuart Graham, a J.P. Morgan & Co. analyst in London. Other European banks seem to be holding back, too.

There are those who believe this is just a temporary respite. But for now, investment bankers are frustrated because they figured they had found a safe approach by doing deals targeting overseas companies expecting payments in U.S. dollars. Last year, Citicorp Securities and ABN Amro Bank arranged a deal that enabled Pakistan Telecommunication to securitize \$250 million in receivables from dollar-paying carriers such as AT&T, Sprint, and MCI WorldCom. Another appeal of these deals is that the arrangers and the issuing company often have other banking relationships, so there aren't many secrets between them, says Alvin G. Hageman, a managing director for global securitization at Citicorp Securities. “At the end of the day, if you do this right, you have incredibly good assets,” he says.

But global liquidity meltdowns certainly don't help fuel growth in any part of the world. Could a bold and massive asset reshuffling of dud loans help Japan escape from its world-class banking mess? Sure. But the betting is that it will happen in Tokyo time—that is, glacially.

*By Brian Bremner in Tokyo
with Thane Peterson in Frankfurt*

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Asset-Backed Gambling?

The sector is more hazardous than many investors realize. In a downturn, that could be trouble

Securitizations are all about guesswork. First, companies guess how much revenue they can expect at a particular time. Then they guess how much of that money they will need to back their bonds safely. Finally, they guess how much cash will be left over—and book that as profit.

And guess what? Sometimes they guess wrong.

So far, though, the bad guesses haven't permanently damaged the investors who have bought hundreds of billions

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of dollars' worth of asset-backed bonds. Investment bankers have done a good job of figuring out how much cash is needed to back the paper. And there has never been a default in any public asset-backed deal, rating agency executives say.

But there is nagging evidence that the guesses could be more off the mark than most players in the market think. To this point, this has hurt companies that issue asset-backed bonds and their shareholders. For example, subprime home-equity lenders—the fastest-growing sector in the asset-backed market—have made terrible guesses about their expected profits and have seen their stocks crash as a result.

The worry is that investors in asset-backed bonds may see problems. If the economy slows sharply, analysts fret, assumptions about loan losses could also prove incorrect.

“Unlike the last recession, when asset-backed securities did just fine, we could see collateral underperform,” says research analyst Janet Braggs at Scudder Kemper Investments Inc. in Boston. “If that happens, there will be more downgrades.”

Moreover, critics worry that securitization depends on a particularly risky assumption—that the markets will always function. “Securitization creates the illusion of unlimited liquidity and marketability,” says Henry Kaufman, the former Salomon Brothers Inc. economist who is now president of his own consulting firm, Henry Kaufman & Co. “This, of course, does not prevail all the time—as has been demonstrated in recent weeks. There are hidden risks in securitization that from time to time result in very substantial losses.”

So far, the biggest threat to asset-backed securities hasn't

of dollars' worth of asset-backed bonds. Investment bankers have done a good job of fig-

“There are hidden risks in securitization that from time to time result in very substantial losses” — HENRY KAUFMAN, Henry Kaufman & Co.



been loan delinquencies but prepayments. In the home-equity world, with so many subprime lenders stumbling over each other to offer better deals to consumers, borrowers took advantage of the bargains and began prepaying their loans at faster speeds than expected. The loss of anticipated income forced issuers to write down their future profit assumptions.

Those revisions unnerved investors who bought stock in the belief these guesses were gospel. “Although it was generally disclosed in the footnotes to the financial statements, I don’t know that investors understood what it meant,” says David M. Thrope, a partner at Arthur Andersen & Co.

The good news in the subprime debacle is that while issuers suffered, their bonds survived. “There has been a huge correction in the asset-backed market, but it has been among issuers,” says Philip N. Weingore

Not a follower



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“ [In a recession,] we could see collateral underperform... there will be more downgrades ” — JANET BRAGGS, Scudder Kemper Investments

a managing director at Credit Suisse First Boston. Still, the failure of issuers could wind up harming the bonds down the road. That's because companies that issue asset-backed bonds usually collect the loans as well. If they go under, someone else has to step in—and that could be a particular problem in some of the new asset classes with few players.

What may be the most controversial part of the market is bonds backed by high-loan-to-value (HLTV) loans, which let homeowners borrow up to 125% or more of the value of their

Special Report

CORPORATE FINANCE

homes. According to the General Accounting Office, 10 companies dominated an \$8 billion market last year—with one, Dallas' FirstPlus Financial Group, doing a third of the volume.

What's more, it's hard to say how such loans will perform in a downturn. “A lot of the rating methodologies are very hypothetical because you are looking at a lot of issuers and securities and asset classes that have a three- to five-year history,” says Jon Prestley, an assistant vice-president at Hartford Investment Management Co. “They haven't been through a recession yet.”

The consolation for investors is that rating agencies run computer simulations on loan pools that assume an outright cataclysm—something on the order of the Great Depression or the collapse of Texas oil in the 1980s.

But the triple-A ratings that result from these exercises have

a flaw—they reflect only the certainty that an investor will see the return of principal. The possibility of prepayment—and the loss of interest income—is not part of the calculation.

And there have been cases of early payment in the asset-backed market involving bonds backed by credit-card loans. Investors in these bonds are paid back early whenever losses in the collateral reach a trigger level.

Ironically, this occurred in the first credit-card securitization—RepublicBank Delaware's \$200 million issue in January, 1987. The bank went bust the next year, and the Federal Deposit Insurance Corp. paid off investors early. In other cases, too, banks have added to collateral to calm worried investors.

The worry now is that loan pools are showing signs of weakness. Meanwhile, some finance companies have gone bankrupt. If these trends continue, there may be no one around to shore up pools of troubled loans in a downturn. And that could mean losses for investors in asset-backed bonds. So there are cracks in the guesswork. And they could get bigger.

By Gary Silverman and Debra Sparks in New York



THE SKEPTIC: 'THERE WERE SCREAMING MATCHES'

“There were screaming matches between the bankers and me,” remembers Thomas Facciola. “Companies would call and threaten to pull investment-banking business, and I was told some did.”

Facciola, a securities analyst at Salomon Brothers Inc. in 1996, was writing negative reports about some of Wall Street's newest and hottest darlings: companies that originated vast numbers of auto and home-equity loans, mostly to risky, “subprime” consumers. “The stocks were given earnings multiples in the 25 or 26 range for companies which had no earnings,” says Facciola in a staccato, fast-paced voice heavy with the accent of Staten Island, where he was born. “Investors were gobbling up the paper like Pac Man. At the time, they were in denial of what was going on.”

But in his 1996 report entitled *All Pain, No Gain*, Facciola was the first to warn investors that companies were using imprudently aggressive



FACCIOLA: He warned investors

accounting assumptions when booking future earnings. He warned that the companies' growth had become a kind of Ponzi scheme. If funding slowed—or if the loans had problems—the companies' “illusional earnings would disappear,” says Facciola.

Today, Facciola, who left Salomon

for a more lucrative offer at Lehman Brothers Inc. in 1997, still covers the specialty finance sector, which is now in a shambles, as he predicted. The vast majority of subprime auto stocks have declined more than 80% since the beginning of 1997. Subprime home-equity stocks followed suit, dropping close to 75% in the same period. “It took less than two years for this sector to go from its peak to absolute implosion,” Facciola says.

Naturally, Facciola's early warning pleases his clients: “Tom has been consistently accurate,” says Alex Greenberg, a partner at hedge fund Ardsley Partners in Greenwich, Conn. “Early on, he anticipated that fundamentals in subprime lending were deteriorating even though the stock prices remained high. He refused to take management predictions at face value.”

For analysts like Facciola, who speak their mind, screaming matches are just part of the job.

By Debra Sparks in New York



*Just weeks after breaking his arm, Hector Ortiz
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[Where his ability to rebound was desperately needed.]*

Liberty Mutual's managed care is as fast as Hector's fast break. After his accident, Hector's employer called our 24-hour claims service hotline. We found the right doctor to treat him, at the right price. A rehabilitation nurse coordinated a return-to-work plan. And through our on-site rehabilitation program, a therapist worked to help Hector properly do his job and avoid reinjury, so today Hector is back on the job (and on the boards) leading a safer, more secure life.

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The freedom of Liberty

By Gary Silverman

SECURITIZATION IS NO SECURITY BLANKET

There's a problem with securitization, and James E. Moore knows it well. He's president and chief executive officer of ContiFinancial Corp., and his business depends on the process; pretty much all he does is make loans and bundle them into bonds to raise more money. But sometimes the whole drill can leave a guy with a headache. "These deals are so outrageously complicated," Moore says. "The thing that's tricky about this business is that it

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kind of looks like it's in English, but it's really math."

It's this elaborate structuring of cash flows that makes securitization work. It's the reason a company like Conti, with a credit rating below investment grade, can issue AAA bonds. But this very complication can lead to the mystification of securitization.

PUSHING THE ENVELOPE. Securitization is a creative way to connect people who want money to people who have it. It does not eliminate risk in lending. Nor does it guarantee financing will always be available. But the Wall Street masters of this universe keep pushing the envelope, pitching securitization to an increasingly wide audience. And that has cost some investors dearly.

"It isn't securitization that is a problem—it's viewing securitization as a panacea," says Hyperion Partners Chairman Lewis Ranieri, who pioneered securitization while working at the former Salomon Brothers Inc. in the 1970s. "Securitization did what it was supposed to do. It was an alternative to the financial system. It could deliver very large amounts of funds at very competitive rates."

A classic example of the perils of securitization can be observed in ContiFinancial's business—subprime home equity lending, which typically caters to borrowers with tarnished credit histories, looking to pay off credit-card or other consumer debts. Since 1996, more than a dozen companies have been taken public to do nothing but make these loans, package them as bonds, and lend again. In almost all cases, the share prices of these companies have crashed this year.

The flaw in this process is that it's a very complicated way to make money. In a securitization, companies essentially promise to use their revenues to pay off the buyers of their bonds—first. Once the investors are paid, the company keeps whatever money is left over. That's its profit.

But how do you book a profit that could take years to materialize? Accountants require the issuers to make an estimate of how much profit they expect—right away, when the bonds are issued—and then to revise that estimate, quarter to quarter, as the cash actually arrives.

This year, among home equity lenders, these estimates proved way off base. Ironically, faster payments deprived the companies of expected interest income. And investors reacted like the police inspector played by Claude Rains in *Casablanca*: They were shocked, shocked, to discover that gambling was being conducted on the premises and unloaded their shares.

But the truly shocking thing was that so many companies went public so quickly to conduct a business that so few people understood. "There was a general lack of understanding of the accounting," says Brenda B. White, managing director of UBS Securities. "It was almost like a drug addict—the accounting became the enabler. It enabled the company to believe the product was worth

more than it proved to be worth."

That shouldn't happen again. The Financial Accounting Standards Board is on the right track when it considers requiring listed companies to provide greater detail about the assumptions they make when estimating securitization profits.

Looking to regulators, however, to save us from securitization may not be very fruitful. The power of securitization is that it bypasses the banking system that is the focus of current regulation. In fact, securitization already has eroded the value of a key regulatory tool—requiring banks to hold a certain amount of capital against loans. Banks now can securitize safe loans—because they don't feel a need

to hold so much capital against them—and keep risky ones. As Federal Reserve Chairman Alan Greenspan has said: "The possibility that regulatory capital ratios may mask true insolvency probability becomes more acute."

The best policy, for the time being, is caution. Securitization is a powerful tool—but only in the right hands. "This business is only for well-managed institutions," says Michael L. Brosnan, Deputy Comptroller of Risk Evaluation & Market Risk for the Comptroller of the Currency. "It's not meant to be done home alone without adult supervision."



Gary Silverman covers banking.

Chaos is all around her.

Good thing answers are right in front of her.

(In online lab reports, X-rays and MRIs.)

She's connected to all of it.

All at once.

When you have the right network, it's a lifeline.

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BY GENE G. MARCIAL

WMS INDUSTRIES IS ALL SET TO PASS GO

Know any Big Board stocks that have surged more than 100% this year? One company that has managed to perform this feat is a small-cap gambling stock: WMS Industries (WMS), whose shares zoomed to 6% on Oct. 13, up from a low of 2½ in mid-June. The stock had been as high as 8½ in late September—before profit takers took away part of the gain. What's behind the sizzle?

Two things: WMS has come out with a hot slot-video machine called Monopoly, and it's whispered that leading slot-machine maker International Game Tech-

nology (IGT) is eyeing WMS as a buyout target. IGT declined to comment, but an IGT insider says: "Some people are looking at WMS to do a deal." One stumbling block to any IGT design is Sumner Redstone, whose privately held operator of multiplex theaters, National Amusements, owns 25.5% of

WMS. Leo Rishty, editor of *Unique Situations* newsletter in Weston, Fla., says: "Redstone may decide that WMS [the top pinball-machine producer] could be a good fit instead for National Amusements, or Viacom International"—of which he's chairman. He bought 250,000 additional WMS shares in May.

In the past few months, the Monopoly machine has become a "quick hit" in Las Vegas. Already used in at least six big casinos, including the Mirage and the Las Vegas Hilton, this variation on the board game Monopoly could produce earnings of more than \$20,000 per machine per year for WMS, based on initial response at the casinos, estimates Rishty. "My guess is WMS will have at least 4,000 machines on location in nine months." A year from now, WMS could earn from \$60 million to \$70 million a year from Monopoly alone, he adds. WMS has a revenue-sharing pact with the casinos: It gets 20% of the

"win" from Monopoly. For fiscal 1998 ended June 30, WMS posted sales of \$98.9 million and an operating loss of \$1.92 a share—which includes extraordinary charges.

Another person who's high on WMS is Michael Wallace of Warburg Dillon Read, who figures that the company will turn profitable sooner than expected, with earnings of 5¢ a share in fiscal 1999—without Monopoly. If Monopoly is successful, "there's upside potential to our fiscal 1999 forecast," says Wallace.

WHO'LL POUNCE ON GRYPHON?

Will property-and-casualty insurer Gryphon Holdings (GRYP) come up with a white knight to ward off an unsolicited bid from specialty insurer Markel? "It looks that way," says Dan Veru, president of Awad & Associates Asset Management, which holds more than 5% of Gryphon. But he thinks Markel, which has accumulated 11.7% of the stock, won't give up easily. Gryphon was first featured in this column as a takeover target on July 14, 1997.

When shares of Gryphon slumped to 11½ on Sept. 1—down from 18½ in late April—Gryphon's board got a surprise offer from Markel to buy the company for \$15 a share in cash plus \$2.50 in notes. Markel has since sweetened the bid to an all-cash \$18 a share. So far, Gryphon's board has ignored the bid.

The stock, trading at 15, is worth 22 to 23, figures Veru. "Surely, the \$18-a-share offer from Markel will be the floor price," adds Veru, who expects the bid to attract others. Steven Markel, Markel's vice-chairman, told Gryphon's board in a letter dated Oct. 1 that Markel was willing to sweeten its offer further "if you can establish that additional value is warranted." Markel notes that it would be "increasingly difficult for Gryphon to survive as a stand-alone entity" because of competitive factors, such as the soft market conditions in the industry.

PAUL HARRIS AIMS TO GET SPRUCED UP

Ever heard of Paul Harris Stores (PAUH)? Its stock has collapsed—from 30 a year ago, to 5½ by Oct. 8. Scary? Not to some players, who have snapped up shares of the Indianapolis retailer of mid-priced women's attire.

"It's one of the best buys in retail," says Harry Ikenson of Hambrecht & Quist in San Francisco. The stock has inched up to 7 recently. Behind the stock's fall were a decline in sales and a 48% earnings dive in the fourth quarter of fiscal 1998 (ended Jan. 1).

There is one other reason investors are buying: "The stock has become so undervalued," says one California money manager, "that Paul Harris could become vulnerable to a takeover." With a book value of \$6 a share and no debt, that possibility can't be discounted in an industry that's consolidating.

To Ikenson, improving fundamentals are reason enough to buy. "The bad news is out, and an upturn is under way," says Ikenson. "Sales trends in October have been excellent," he notes, and inventories are "in good shape and merchandise margins are up from last year." The company is building up its brand name—in the same way that Gap uses its name as its image.

When the stock sank, management accelerated its stock-repurchase plan. By late September, it had bought 410,000 shares at an average of \$9. It's likely the company will authorize more buybacks if the stock hangs low. Ikenson expects Paul Harris, which runs 290 stores in 29 states—mostly in malls—to open 21 stores this year.

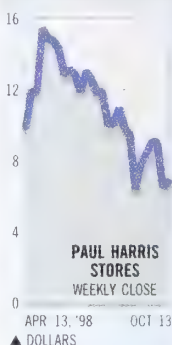
His 12-month target for the stock is 19. For 1998, he sees earnings of 95¢ a share on sales of \$250 million; for 1999, \$1.18 on \$299 million.

ONE OF THIS YEAR'S BEST BETS



DATA: BLOOMBERG FINANCIAL MARKETS

LOOKING A BIT THREADBARE



DATA: BLOOMBERG FINANCIAL MARKETS

AN INSURER IN A SLUMP



DATA: BLOOMBERG FINANCIAL MARKETS

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EDITED BY CATHERINE ARNST

GETTING ALL RADIOS THE SAME LENGTH

DECADES, THE MOBILE radios used by taxi dispatchers have been plagued by a blem that troubled older generations of computers: frequent makes were incompatible and couldn't "talk" to each other. For the computer world, change came with cell-based PCs. Now Motorola Inc. has come up with what it hopes will be the PC of the radio world: a modular radio.

The new device is a 40-milliwatt digital computer with a radio transmitter and receiver built in. The radio's bandwidth, modulation, and other features can be reprogrammed so it can communicate with other radios. The U.S. Navy has said it will spend up to \$337 million worth of the radios over five years. While sales in the beginning will be confined to the military and public safety organizations, Durrell W. Hillis, vice-president at Motorola's Systems Solution Group, says that fleets of trucks, taxicabs, planes, and boats all could employ the technology. *Stan Crook*

MOTHER NATURE IS STRIKING BACK

A NEW ANALYSIS OF POPULATION, CLIMATE CHANGE, pollution, and disease concludes that mankind has nothing to fear but mankind itself. In a study published in the October edition of the journal *BioScience*, a team of researchers from Cornell University report that 40% of the world's deaths are due to human degradation of the environment.

David Pimentel, an agricultural sciences professor at Cornell, headed a team of 11 researchers who analyzed data from a variety of international sources, including the U.N.'s World Health Organization and the U.S. Centers for Disease Control. He acknowledges that the data are not exact, noting that it is difficult to "decide whether death is from malnutrition or a waterborne disease." But his team, says Pimentel, stuck strictly to the death classifications used by official government bodies. Among their conclusions:

- Cigarette smoking causes 3 million deaths worldwide each year, with two-thirds in developing countries.
- About 3 million human pesticide poisonings are reported globally each year, leading to some 220,000 deaths.
- Smoke from indoor cooking fires causes the death of an estimated 4 million children a year globally.
- Lack of sanitary conditions contributes to approximately 2 billion diarrhea infections and 4 million deaths annually.
- There are 1.2 billion people in developing nations that lack clean water, and waterborne infections account for 90% of all infectious diseases in those countries.
- An estimated 1.7 million children in the U.S. have dangerously high levels of lead in their blood.
- Radon radiation in the U.S. is considered a significant cause of lung cancer, leading to 14,000 deaths a year.

Pimentel says humans are, more than ever, living in crowded urban centers that are ideal for the spread of disease, exacerbated by malnutrition and an unprecedented increase in air and water pollution. □



A FASTER METHOD FOR DETECTING E. COLI

THREE PROFESSORS AT THE University of New Mexico at Albuquerque have come up with a fast, portable method for testing bacteria such as *E. coli* and salmonella in meat and produce before the food hits supermarket shelves—and not a moment too soon. Some 9,000 Americans die each year from food contamination, a circumstance that caused President Clinton to issue an executive order in August requiring improved inspection efforts.

Right now, tests of perishable food are far too time-consuming. The most common method places food samples in high heat in a laboratory until the bacteria multiply to the point where they can be easily spotted with a microscope, a process that takes about 48 hours. By the time the results are known, the tested products are on store shelves.

Ebtsam Wilkins, Plamen Atanasov, and Andrey Ghilindis, chemical engineering professors at the University of New Mexico, have come up with a shoebox-size device that they say detects contamination in 10 to 20 minutes. It is based on a chemical test, called ELISA, that uses antibodies to detect bacteria. The antibodies are attached to enzymes that can be quickly detected and counted electronically. BioDetect Inc. in Albuquerque has licensed the detector and expects to have it ready for market in two years, at a price of about \$1,500. *Nellie Andreeva*

NOW, HIGH-DEFINITION HEARING AIDS

FOR THE 25 MILLION HEARING-impaired Americans, 90% have problems that could be fixed by a hearing aid. But only 20% have bought one, says the Better Hearing Institute. And almost half of those return it, citing poor sound quality or poor fit. The latest attempt at a better hearing aid is the tiniest yet of a new generation of digital devices—the Natura, small enough to fit deep to the ear canal.

Unlike analog hearing

aids with only bass and treble controls, digital aids introduced over the past two years have multiple frequency channels that can be fine-tuned to each patient's requirements. The Natura, made by Sonic Innovations Inc. in Salt Lake City, is built around a proprietary digital signal-processing microchip with nine audio channels programmed by a handheld computer. Craig Newman, head of audiology for the Cleveland Clinic

Foundation, says the device allows him to "precisely fit each hearing aid to my patient's exact hearing needs." It costs from \$2,200 to \$2,600. □



e. From now on, however messy the process, no high-tech industry will be left untouched. Fortunes will be made and lost as broadcasters, cable operators, computer makers, consumer-electronics companies, and many others scramble for positions in the shifting digital hierarchy.

Some industries will see their worlds turn upside down. Cable seems the best-defended, with its lock on American homes. But if broadcasters and TV makers capture the digital living room, companies such as Dell Computer, Compaq, and Intel could have a problem. Who needs a Pentium PC if simpler, cheaper appliances let you browse the Web or videoconference with friends on a giant high-resolution screen? Broadcast equipment makers, such as Harris Corp. and Lucent Tech-

nologies, Inc., are already having a heyday. Hollywood and the computer-game gang also stand to gain, as interactive-TV programmers look for more compelling content.

But for broadcasters more than any other group, this is Digital D-day. Networks and their affiliates are dead last to climb aboard the digital bandwagon,

while industries competing for the same eyeballs are already well on their way. Eight million American households already get TV from satellite broadcasters via transmissions that are 100% digital (although viewers are watching the signals on conventional analog

Cover Story

D-DAY

On Nov. 1, HDTV makes its debut. Is anyone ready for this big event?





GAME COMPANIES

Video games look great on big, wide screens—a point not lost on Nintendo,

Sony, Electronic Arts, and other game-masters. They may release new titles that take advantage of the screen and exploit it in online games, too.

CABLE SYSTEMS

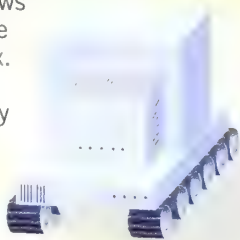
Cable systems are at odds with broadcasters. Cable is experimenting with fast cable modems and flashy set-top boxes that link TVs to the Internet. But right now, cable can't display broadcasters' HDTV signals.

If you want digital TV, you'll need an antenna.



COMPUTER COMPANIES

Microsoft is working with cable, positioning Windows CE as key software for the set-top box. Compaq and Gateway did poorly selling large-screen PC/TVs for the living room, but they'll probably come out with low-cost set-top boxes or other appliances.



BROADCASTERS

Most will offer some high-definition programming, to see if it attracts viewers. Some may split their new broadcast spectrum into 6 or more standard-definition channels, which they'll use for local programming, pay-per-view movies, or fast Internet service. No one has come up with a slam-dunk business model.



TELECOM, CHIPS, AND DATA-NETWORK COMPANIES

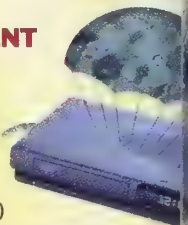
TV stations preparing for digital broadcasts are buying expensive new equipment from Lucent Technologies, Harris, IBM, and many digital-broadcast startups. Cisco and Northern Telecom can send high-speed switches to route the digital signals.



Digital TVs are in the stores, but consumers are rightly wary. Every industry has a different take on digital TV, spelling a long, messy transition. Don't touch that dial!

TV EQUIPMENT MAKERS

They think digital TV is a gold mine. The new sets, costing \$5,500 and up, carry cushy premiums, and may also spur sales of DVD players, VCRs, and audio gear. But technical glitches could foil the launch. And confused shoppers may decide to wait—slowing sales of regular TVs as



SATELLITE BROADCASTERS

DirecTV/USSB and EchoStar Communications are starting high-definition broadcasts. Startups such as St. Louis' Unity Media are leasing transponders on satellites to beam high-definition movies and programming to areas that can't receive digital broadcasts.

THE U.S. GOVERNMENT

It wants to speed broadcasters' introduction of HDTV, especially since the industry was given extra airwaves for free. The faster HDTV takes off, the sooner the Feds can reclaim and auction off airwaves now used for analog broadcasts.



HOLLYWOOD

Movie studios and cable pay-per-view programmers won't release new shows for high-definition TV until copyright issues are resolved. They're worried about illegal copies made on digital VCRs. But Sony is converting hundreds of older films into high-definition formats.



s). Cable systems will have spent \$33 billion on digital upgrades by 2001 and are beginning to offer 300 channels, high-speed Internet access, and even TV Web-browsing. PC makers, noting slower growth, are mapping their own thrusts into the living room. Web startups are snatching away viewers with alluring online games and chat rooms. "We're not going to remain in the analog world for long," says Federal Communications Commission Chairman William E. Kennard.

But the road from broadcasters' analog past to the digital future is already beset with technical fumbles and fiascos, along with shaky broadcast business plans—or, worse, no plans at all. He heralded as a gold mine, digital TV is starting out as a mixed field. Contrast this with the last big change in TV: from black-and-white to color. In the 1950s, one company, RCA, controlled key segments of the business—from TV-set making to the NBC network. Today, a dozen different industries all want to step into RCA's shoes.

If this is the broadcasters' last stand against their rivals, it's an auspicious start. Advertisers are reluctant to spend anything on HDTV until there is an audience. And here's another hitch: Cable operators, whose customers make up 67% of all watching homes, have resisted carrying broadcasters' digital programs.

Nearly, cable will be hard to beat, even when broadcasters are armed with new digital transmissions. Attempting to break the cable's stranglehold, frustrated broadcasters such as Rupert Murdoch's Fox Broadcasting Co. are backing off TV programming altogether. Fox and others are experimenting with alternative uses for the airwaves allotted for HDTV. One radical—but legitimate—option is splitting the spectrum into six or seven digital channels. If several local stations are bundled together, they could create the equivalent of a miniature over-the-air cable system that might cost a far more money than a single HDTV channel. It's puzzling that broadcasters are still searching for moneymaking schemes in digital TV, after all the pains they took to get it. In 1996, after a decade of fierce lobbying by broadcasters and TV makers—mostly European and Japanese—Congress lent TV stations a sliver of an extra six-megahertz slice of the airwaves for free, to transmit digital TV. That was in addition to their existing analog spectrum. By law, stations in the top 10 markets must begin these broadcasts by next May, but most are starting this fall. Stations in the top 30 markets must start by next November, and the rest by 2003. By 2006—or whenever 85% of viewers finally get digital TV—broadcasters are supposed to turn their analog airwaves. Then, the government could auction it off for new uses. But it could take two decades before the market hits 85%, according to Paul Kagan Associates.

THE DREAM. Broadcasters won't get far with HDTV unless consumers buy the sets. And with prices in the stratosphere, prospects for that are uncertain. "It's a pipe dream that large numbers of people will spend \$6,000 to \$9,000 on a new TV," says David E. Mentley, vice-president for display research at Inford Resources Inc. in San Jose, Calif.

Confusion and unresolved technical problems could also frighten buyers away. The expensive HDTV sets on sale this fall can handle many different display formats (page 150). At the extreme stands HDTV, which more than doubles the number of scanning lines that form TV pictures. Other formats are only slightly better than ordinary TVs. Shoppers will face a dizzying array of choices—just as PC buyers must learn their way around megahertz and megabytes.

If a salesperson tells you, for example, that the HDTV you are chasing today is "future-proof"—that it will cope with all coming improvements—then you should shop somewhere else.

Digital TVs are like PCs: The one you buy today may look dated next year. None of the first crop of HDTVs in stores

now can display all the information, or "pixels," in an HDTV broadcast. In five years, or maybe 10, they will all do so.

The set you finally buy will need careful testing. In the rush to HDTV, broadcasters' technical committees didn't have time to test all the different broadcast gear against the sets of all manufacturers. The "encoder" boxes used at stations to prepare the digital signals for broadcast aren't identical. So sets purchased by consumers in some areas may not be able to decode the signals from the local TV station.

Then there's the dreaded "cliff effect." As signals on the airwaves bounce between buildings and other obstructions in big cities, they get muddled, a

phenomenon known as multipath. It's an especially serious problem in UHF bands allotted for digital broadcasts. If this happens with analog signals, viewers get static or blurry artifacts called ghosts. With your new digital TV set, the image simply "falls off the cliff"—the screen goes blank. The sets are not at fault. Instead, some of the technology for digital transmission is not robust enough, and broadcasters have not tested it in varying geographies.

The Consumer Electronics Manufacturers Assn. (CEMA) says that setmakers can correct such problems with more powerful antennas. "Don't worry, we'll get it worked out," insists CEMA President Gary Shapiro. But engineers can't patch problems until they understand them—too late, in this case, to help "early adopters" who purchase the first digital sets.

Equipment makers just want to sell the heck out of giant HDTVs. These range from \$5,500 to \$10,000

and up, and deliver fatter profit margins than current sets, even large-screen ones. Some, like the Panasonic HDTV that Anna Galloway uses in San Diego, are sold like monitors, and the tuner/decoder boxes are sold separately. William L. Mannion, general manager at Panasonic Consumer Electronics Co., a unit of Matsushita Electric Industrial Co., predicts that all HDTV vendors combined could sell about 50,000 digital TVs in the next 12 months, including set-top boxes.

To create consumer momentum, Sony Corp. is subsidizing CBS's high-definition National Football League broadcasts. And Philips Electronics will spend \$100 million in the coming year to promote digital TVs and other products. "This is a gold rush," says Cees Jan Koomen, president and CEO of Philips Consumer Electronics in Palo Alto, Calif. Koomen and others believe flat screens will eventually replace today's hulking space-hogs. Large plasma screens from Fujitsu, NEC, or Pioneer cost \$10,000 or more. For top performance, HDTVs may always cost that much. But in a few years, there should be some wide-screen digital TVs offering less-than-HDTV resolution for under \$1,000.

If the future is bright, the present is anything but. Without new TVs in viewers' homes, how will broadcasters make the digital gambit work? There's no easy answer. HDTV was never linked to any proven market demand. The campaign for HDTV started in 1986 as an effort by the National Association of Broadcasters (NAB), to keep control of the airwaves. Motorola Inc. and other companies were then demanding a slice of the broadcasters' unused frequencies for two-way radio service. The



THE LOOK
On a small screen,

HDTV isn't so impressive. But on a wide screen with high-quality surround sound, it's dazzling

Cover Story

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broadcasters insisted that they needed to keep their spectrum in order to launch HDTV, so they could catch up with Japan, which was ready to test its own HDTV plan.

Now that they have it, how do they make it pay off? Big money is being spent. The

NAB estimates the nation's 1,576 TV stations will shell out \$16 billion over the next 10 years to convert to digital. Still, without enough TV sets out there, broadcasters have little incentive

to produce HDTV programs—which can cost \$25,000 more per hour than ordinary shows. (That might not sound like much, but it adds up. There are 11,000 prime-time hours in a year.) And without programming, viewers won't be persuaded to buy HDTVs. "Nobody has come forth with a convincing business plan," says CBS Senior Vice-President Martin Franks.

There are almost as many strategies as there are channels on the dial. ABC will start by airing the Disney movie *101 Dalmatians* in HDTV. NBC will start showing *The Tonight Show with Jay Leno* in high definition next spring and the films *Men*

Cover Story

DEFINING TERMS ON HIGH DEFINITION

High-definition televisions are in the stores, with pictures—and prices—that will take your breath away. The sets start at about \$5,500, which is enough to discourage most shoppers. And they're not fully standardized—another good reason to wait. If you really want to buy now, here are the basics:

Do I really need a digital TV?

No—or not yet. Until at least 2006, broadcasters will continue to "simulate" any new digital or HDTV programs in analog form, viewable on any TV. After that, so-called converter boxes costing less than \$500 will convert the digital signals for older TVs.



What do words such as "480i," "720p," and "1080i" mean?

These are three of the 18 display formats that the Federal Communications Commission has approved for digital-TV broadcasts. The numbers refer to scanning lines that make up a TV picture. "I" stands for "interlace," a way of splitting and scanning images that is used in today's analog sets. The alternative is progressive ("p"), where all the lines of the picture are scanned in each frame. Computer monitors use this approach. Roughly speaking, 480i means picture quality equal to today's best analog sets. True high definition begins at 720p. The best you will see on today's HDTVs is 1080i.

Will TV pictures ever exceed 1080i?

Yes. In a few years, even better 1080p displays will be available. What's more, none of today's HDTV

sets can display the full number of picture elements that some broadcasters are sending—1,920 pixels on each horizontal line. Professional monitors that can show that kind of resolution cost about \$25,000.

Does a digital TV need a separate set-top box to display images?

Some manufacturers, such as Sony, have built tuner/decoders into the TVs. Others sell the monitors and set-tops separately. There are good reasons for that. The technology is

WHAT IS DIGITAL TV?

A digital TV receives signals as computer code, produces sharper images than a conventional TV, and includes digital surround sound. But not every digital TV is an HDTV. Here are the differences:

HIGH-DEFINITION TV (HDTV)

- ▶ Pictures consist of at least 720 progressive scanning lines
- ▶ Has a wide screen like a movie (the tech term is "16:9")
- ▶ Offers Dolby Digital audio or equivalent

STANDARD-DEFINITION TV (SDTV)

- ▶ Picture resolution is less than 720 scanning lines
- ▶ Sound is digital audio, but not necessarily Dolby
- ▶ Displays any digital broadcasts, but not with HDTV clarity

DATA: CONSUMER ELECTRONICS MANUFACTURERS ASSN

still evolving, and the "interfaces"—meaning jacks and sockets for connecting different components—are not yet standardized. Compatibility with cable is also up in the air. That means changes might be needed in the set-top box's electronics.

Do you mean the new sets can't connect to cable?

It depends on what you mean by "connect." You can plug them in and watch ordinary cable programs. But your cable box, right now, can't decode the new digital broadcast signals. To watch the broadcasts in digital form, you'll probably have to put an antenna on the roof, and maybe use a separate converter box.

Then what's the big advantage of digital television?

There are many. First, the digital broadcasts will look great—if you can receive them. In addition, most of the digital sets will clean up analog signals, using tricks such as "line-doubling" to make certain TV shows look crisper. Some of the wide-screen models will subtly "stretch" ordinary TV shows to fill up the screen, giving a more cinematic look. A new generation of digital video disk players, arriving this fall, will allow "digital to digital" output, meaning the images will be displayed exactly as they were recorded.

Are there other cool applications?

Most of the sets will double as giant computer monitors. And low-cost digital "appliances" are on the way, which will facilitate Web-browsing, video-conferencing, 3-D chat, and video games. All of these activities are a lot more compelling on giant, high-

resolution screens than on cramped PC monitors.

Is HDTV better than a digital satellite-TV system?

Your satellite picture right now, on an analog TV, is as good as most low-end digital TVs will deliver. But there's no question that the picture on an HDTV set showing high-definition programming is far better than anything you get on today's satellite systems. Soon, Hitachi and RCA/Thomson will sell digital TVs with built-in HDTV and satellite receiver circuitry. These sets will display all digital-TV formats plus ordinary satellite programs and new HDTV satellite signals.

By Neil Gross in New York



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in *Black* and *Titanic* down the road. Affiliates will likely go with digital sports shows first and then produce their own high-definition local newscasts. "We're going in early for competitive reasons," says Michael J. Fiorile, CEO of the Dispatch Broadcast Group, which owns a CBS and an NBC affiliate. A. H. Belo Corp., with stations in Dallas, Houston, and Seattle, is also mounting an aggressive HDTV strategy (page 158).

Broadcasters think that digital TV could be a potent weapon against the encroaching cable networks. For years, broadcasters have bristled at cable-only channels such as CNN, ESPN, and HBO, which siphon away advertisers and get subscription revenues via the cable and satellite operators that carry them. According to Warburg

Dillon Read, cable-TV advertising will grow 15% annually through

Cover Story

2000, outpacing the 5% to 7% growth of the networks.

Now, broadcasters think prettier pictures will deliver a premium look, giving them an edge over smaller specialty cable channels, such as the Food Network, that can't afford to produce shows in high definition. Well-heeled cable channels, though, are already hatching HDTV plans: Both HBO and Discovery Network plan next year to offer high-definition versions of their service, charging high subscriber fees.

THE BATTLE Cable companies and broadcasters are at odds on digital TV. The cable guys are resisting broadcasters' requests to carry their HDTV programs

give sports fans even more views on the action. Says Fox TV Network President Larry Jacobson: "We can have the Mark McGwire-cam."

RAISING HACKLES. It sounds good, but where are the bucks? Fox's Jacobson is also looking at straight, cable-like pay-per-view. This, too, is fraught with challenges. Most broadcasters have never had to deal with individual subscribers and have no means of billing them. "Challenging cable to a war would be like a Civil War army taking on General Patton," says Nat Ostroff, vice-president for new technology at Baltimore's Sinclair Broadcast Group.

Meanwhile, the very suggestion of such "multicasting"—splitting the allotted spectrum—has raised the hackles of lawmakers in Washington. The FCC is likely to impose a levy on such services. After all, Congress lent the airwaves to the

broadcasters for free, despite budgetary pressures to auction them off. "We didn't intend to give spectrum to them for any purpose other than over-the-air broadcast," says House telecom subcommittee Chairman W.J. "Billy" Tauzin (R-La.). He would like broadcasters to air at least some HDTV programs. Otherwise, the spectrum give-away "would be unfair to other communications players who had to buy theirs," he says.

Cable companies did spend billions—not to buy spectrum, but to upgrade their systems. Now, they're on their way to owning the digital battlefield. They have added fiber optics, better set-top boxes, and more powerful computers and switches. Using the same compression and encoding tricks employed by satellite broadcasters, they will soon be squeezing 10 or 15 channels into the space that used to carry just one.

Broadcasters may try to enlist cable operators, to help launch HDTV. But the cable

HOME THEATER: Large plasma screens, such as this 42-inch display from Fujitsu, can run \$10,000

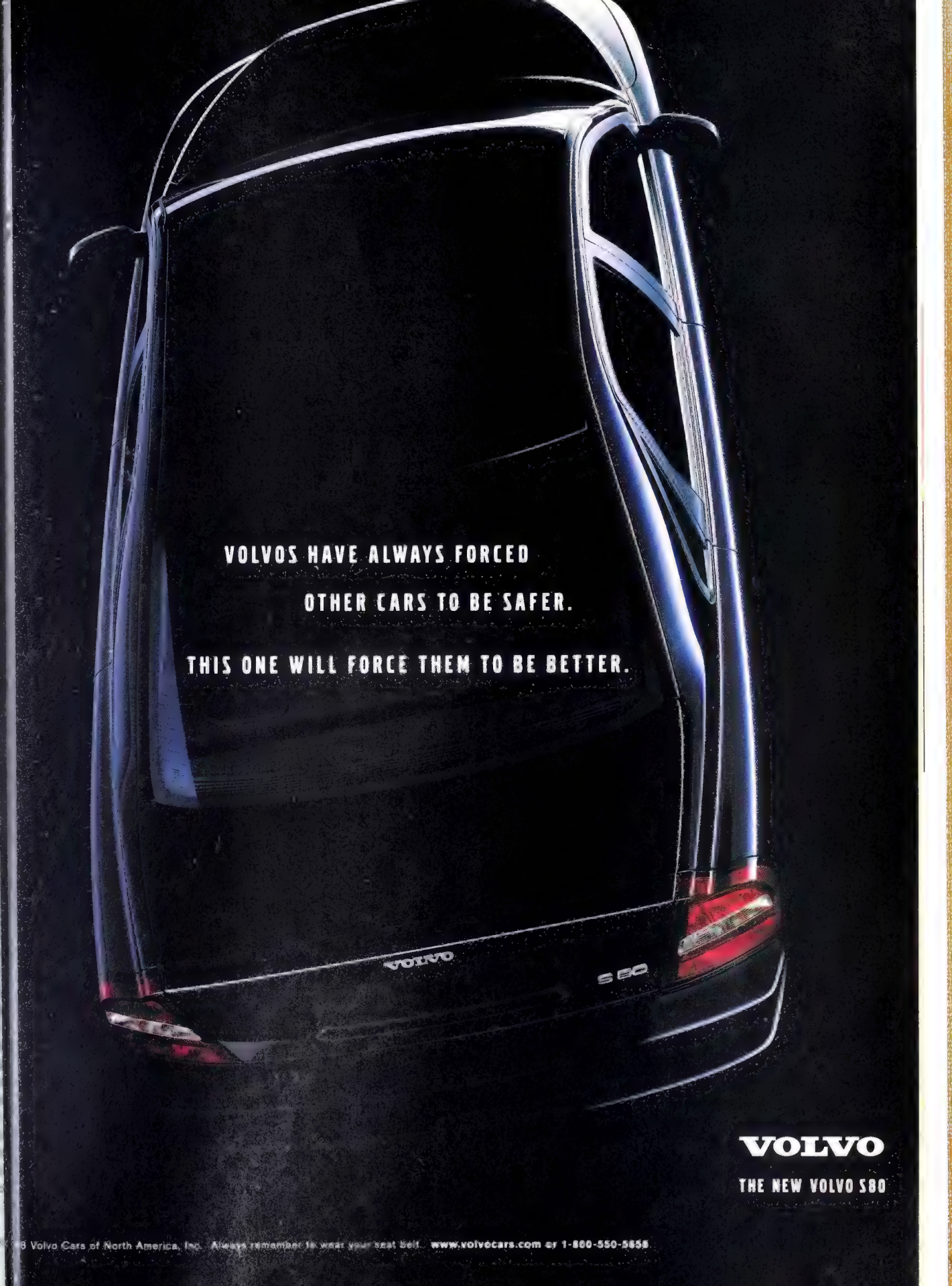
industry hasn't gone out of its way to make its systems technically compatible with digital broadcasts. At this moment, cable boxes can't display HDTV broadcasts at all. The two industries use different "modulation" schemes—the methods of getting digital bits onto so-called carrier waves. Cable systems and digital transmissions can theoretically be made to work together—and it might happen in time for the Nov. 1 broadcast. But the solution could require servicing equipment in the homes of early purchasers of the new HDTVs.

To make matters worse, cable operators may not agree



Broadcasters don't levy any such fees, and HDTV may not allow them to charge premium ad rates. "We never ended up charging more for color [after black-and-white]," notes Charles H. Jablonski, NBC's vice-president for broadcast and network engineering. Even the few advertisers interested in HDTV now aren't sure when they would pay more for those ads. "There's only three people watching, and we don't have any way today to track them," says Jim Gosny, associate director of commercial productions at Procter & Gamble Co., which has produced seven experimental ads in high definition.

Some broadcasters, sharing that skepticism, are mapping out strategies that don't involve HDTV. In fact, there are many ways to use multiple channels: Fox, for example, could replay hit shows in different time slots. (Imagine reruns of *Beverly Hills 90210* at 6, 7, 9, and 11 o'clock.) The networks also could

A high-contrast, black and white photograph showing the rear three-quarter view of a Volvo S80. The car is dark, and the background is black, making the metallic highlights on the car's body panels stand out. The rear window, C-pillars, and trunk are visible. The text is centered over the rear window area.

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PART #325:

Asset Management



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STORY #7:

Meanwhile, Back at the Ranch

PRETEND you're an IS manager with a mobile sales force of hundreds and an endless trail of computers, components and configurations to follow. It's your job to (somehow) control them all—much like a modern-day herdsman. But keeping track of steer is one thing. Wrangling notebooks is quite another.

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carry broadcasters' new digital programming. By law, cable systems are obliged to transmit broadcasters' existing analog channels—but not necessarily their new digital telecasts. Broadcasters say their huge investment in digital TV will go down the tubes if cable doesn't carry the new programs and nobody sees them. "It's like bringing a baby into the world and not supporting it," says Sinclair's Nat Ostroff.

But Atlanta's Cox Communications Inc. and other cable operators don't want to give up any room on their pipe for nothing. "Bandwidth is the single most important asset we've got," says Lynne Elander, director of product development at Cox. "We've spent

billions of dollars of investment on it, and we're not in the position to be paring it away willy-nilly."

Capitol Hill is not amused by this wrangle. Although the FCC prefers to let the networks negotiate their own deals for carriage with the major cable systems, lawmakers threaten tougher cable "must-carry" legislation. If the FCC punts, "I'm almost certain Congress will act," says Rep. Tauzin.

SCRAMBLE FOR CONTENT. Now, with the exploding popularity of the World Wide Web and the premium consumers place on interactivity, cable has landed in the catbird seat. Its upgraded connections allow for two-way interaction, including fast Internet cruising. In contrast, to browse the Web over satellite or terrestrial broadcast, consumers have to tie up their phone line. The cable industry is now gearing up to sell everything from more TV channels to phone service to video-on-demand movies and interactive TV. With its massive audience, it is the linchpin industry of digital convergence. "Cable is the ultimate infrastructure," says Time Warner Inc. chairman Gerald M. Levin.

As digital convergence gathers force, Hollywood and computer-game makers are ready to cash in on the scramble for better content. Sony, for one, has already converted a library of 300 films to high-definition format ready for broadcast. And hundreds of movie titles for digital video discs are already formatted for digital broadcast as well. But with new digital VCRs due out soon to accompany HDTVs, Hollywood is unlikely to unleash its shows without copyright protections built into HDTV systems.

Meanwhile, Silicon Valley is eyeing digital TV warily. Computers, after all, are in just 43% of U.S. homes—most of which have more than one TV. The PC camp fears that digital TVs could supersede PCs as the entry point to the Web. Intel, Microsoft, and Compaq have suffered a string of humiliations in

ALL-DIGITAL STUDIO: NBC will start airing *The Tonight Show* with Jay Leno in high definition next spring

the TV arena. Their early designs for PC/TV hybrids have gone nowhere. And they didn't dominate the first incarnation of digital

broadcasting—namely, satellite TV.

Microsoft Corp. and Intel Corp. have also failed to seize control of digital cable boxes, although moguls such as Tele-Communications Inc. Chairman John C. Malone have been careful not to shut either company out. All Microsoft and Intel have managed, so far, is to make minority investments at the edges—Microsoft in Comcast Corp. and in the Road Runner cable-modem service and Intel in At Home, another cable-modem service.

Intel and Microsoft scoff, however, at the notion that an \$8,000 HDTV set is a winning convergence product. Instead they're pinning their hopes on set-top boxes and other appliances, which will also work with digital TVs. Compaq Computer Corp. hopes to supply sub-\$300 set-top boxes that hook into a home network. "If you want to place bets, Intel, Microsoft, and Compaq will be there at the end," says Trey Smith, Compaq's vice president for advanced products. Add Thomas A. Galvin, director of market development at Intel's content group: "TV is just another form of information delivery that's going digital."

At the digital dawn, each industry is racing for higher ground. People have compared the birth of terrestrial digital broadcast to the transition from black

and-white to color TV in the 1950s. They're wrong. It's vastly more complex and risky. "It's more like the transition from radio to TV," says Fox's Jacobson. The visual improvement may not be as obvious. But the impact on industry is greater.

Today, broadcasters have the hardest road ahead, and PC companies have a lot of adjustments to make. Cable companies rule the roost for now, at least. And whichever camp the future favors, better pictures speak big bucks for the Sonys and Philipsses of the world. If Intel and Microsoft are in



THE MARKET
*In 2004,
HDTVs will*

make up less than 2% of cathode-ray-tube TVs sold in North America, according to Stanford Resources Inc.

a pace. You bang your head against the wall. You do everything in your power
satisfy your shareholders. Except talk to the people who could help you the most.



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It's time for clarity.

tight corner, they'll likely innovate or buy their way out of it. Consumers will get clobbered with choices. We will all become guinea pigs in experiments with convoys of new digital gear, rife with complex incompatibilities. "It will take a lot of work to put the last 50 years of broadcast, the last 20 in cable, 15 in PCs, and five for the Internet—all at the same time—on the home screen," says Steven Guggenheimer, Microsoft's group product manager for

Cover Story

digital television. "It requires cooperation." Right now, that's the last thing on anybody's mind.

By Catherine Yang in Washington and Neil Gross and Richard Siklos in New York, with Steven V. Brull in Los Angeles

BusinessWeek **ONLINE**

For more stories on HDTV, go to www.businessweek.com.

WILL THEY ROPE 'EM WITH DIGITAL IN DALLAS?

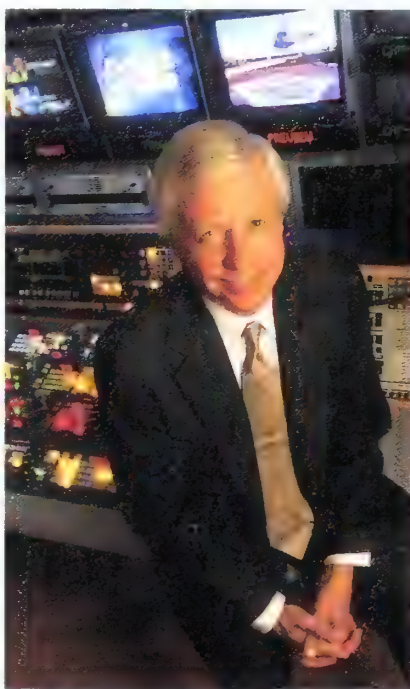
Big Tex, the world's only 52-foot-tall, talking-and-waving cowboy, wasn't the only larger-than-life attraction at this fall's Texas State Fair. In addition, Dallas television station WFAA managed to captivate fairgoers with a preview of the lushly detailed high-definition images that it will begin broadcasting on Nov. 1.

Indeed, many TV-station-owners wonder whether HDTV is nothing more than a wildly expensive carnival attraction—requiring millions of dollars of new equipment for broadcasters and new TV sets on the part of consumers. Some broadcasters across the country are scrounging around for other uses for the digitized airwaves.

Not WFAA-owner A. H. Belo Corp. Dallas-based Belo is betting big that high-definition TV will help it lasso more viewers, as people begin buying the sleek new sets. The company has earmarked \$137 million to convert its 17 stations, which stretch from Honolulu to Norfolk, Va., by 2003. Through its affiliation with ABC, WFAA's first high-definition broadcasts will consist mainly of movies and sports.

NOSE FOR NEWS. But Belo executives are counting on this programming to keep viewers tuned to his channels and even to boost viewership of what really matters to Belo's bottom line: top-rated local newscasts. News programs make up about 20% of WFAA's lineup, yet they bring in 45% to 50% of all revenues, and an even higher percentage of profits. Belo's stations reported earnings of \$48 million, on revenues of \$163 million, in the quarter ended June 30. The higher the station's audience ratings, the better it does in Dallas' \$500-million-a-year TV-advertising market. "We really believe the high-quality product will win out," says Ward L. Huey Sr., president of Belo's broadcast division.

Fellow station-owners don't all



HUEY: Counting on HDTV movies and sports to boost news ratings

share Huey's zeal for HDTV. (Even so, all of the country's 1,576 stations will be required to convert to digital broadcasting in the course of the coming decade.) Among the skeptics is Baltimore's Sinclair Broadcast Group, which owns or programs 56 stations. Instead of using the airwaves allocated by Washington for high-definition broadcasts, it plans to transmit more standard-definition TV. Once they are digitized, as many as six regular channels can be compressed into the same space as a high-definition television signal. That opens up the possibility of broadcasting popular shows in multiple time slots, carrying new channels, or using spectrum for other services, such as paging.

Why no HDTV? Sinclair serves mostly midsize markets and doesn't share Belo's news focus. Plus, the smaller the market, the longer it will

take for sales of HDTVs to justify broadcasting in the jazzy format. Even those who are bullish on high-definition don't expect to air it all day. In fact, broadcasters may also choose to transmit high-definition images that are not of the highest clarity (low-high definition, if you will), conserving spectrum for other uses. "The way we're looking at the digital spectrum is: We've got a commodity that we think lots of uses are going to develop for," says Dennis J. Fitz-Simons, president of Tribune Broadcasting Co., which owns 18 stations. "We think there's ultimately a lot of value out there."

HEAVY ON JUICE. The payoff won't come in the short term, however. WFAA need look no further than its own half-finished digital control room to realize that there is a complicated scramble going on. With its HDTV launch just days away, WFAA has yet to install more than half the equipment it needs—including a master control switch and a studio-to-transmitter link. "Debugging will happen on the air," says Bob Turner, Belo's vice-president for engineering.

There's also the expense of maintaining both an analog and digital channel. All but one of Belo's 17 new digital frequencies are UHF—and a UHF signal consumes \$30,000 a month in electricity, compared with \$1,000 for VHF. For big markets such as Dallas, analysts think the added cost of HDTV is worth it. Says William Myers of BancBoston Robertson Stephens: "There's no direct economic return, but it enhances the quality of their overall product."

It's no wonder, though, that Belo has tried to hasten the acceptance of HDTV with public demonstrations. The broadcaster can only hope that, by next year, high-definition TV will be so enticing that some Texans will skip the State Fair and stay home to watch it.

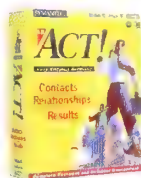
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EDITED BY AMY DUNKIN

RECESSION PLAY: LOOK FOR THE DIVIDENDS

As the bear market savaged energy stocks last summer, Vic Dura spied an opportunity. After examining many companies' prospects, along with their price-earnings ratios, he came up with a half-dozen possibilities. He looked closer and crossed Noble Drilling and Cooper Cameron off his list. Why? Neither

pays a dividend. "Companies can play around with earnings and estimates, but they can't play around with a dividend. Either they paid it or they didn't," says Dura, an engineer in Rogersville, Ala., who works for telecom-gear maker TXPORT. In the end, Dura settled on oil-services giant Halliburton and Diamond Offshore Drilling, yielding 1.8% and 2.3%, respectively.

Dura is pursuing a strategy used by market pros impressed that dividends, over the long run, have provided over 40% of the total return on equities. By buying stocks that pay out part of their earnings as dividends, they're building portfolios that are relatively high on return and low on risk.

FOCUS ON FEAR. Right now, dividend-paying stocks figure to get increasing attention as investors, eager to preserve capital, focus more on fear than greed. "In a recessionary environment, a higher-yielding stock approach is a good one," says T. Rowe Price Dividend Growth Fund manager William Stromberg, who notes that zippier, but riskier, growth stocks often pay no dividend. Joseph Lisanti, the author with Joseph Tigue of *The Dividend Rich Investor* (McGraw-Hill, \$14.95), adds that divi-

dend hikes accelerate during bear markets. "Management wants you to hold on to your shares," he says. "They don't want selling pressure."

There's no shortage of dividend-paying stocks, of course. On the New York Stock Exchange, more than half of the 2,905 common issues offer dividends. But remember that a dividend can be cut—a move that almost always sends the stock price tumbling. The best strategy, Stromberg suggests, is the simplest: "Find proven companies. Buy them when they are temporarily out of favor, then forget you own them."

Some out-of-favor companies got that way because they're truly in trouble. One way to winnow out the losers is to follow the strategies of Anthony Spare, a manager of more than \$1.5 billion at San Francisco's Spare, Kaplan, Bis-

chel & Associates. Spare, the author of *Relative Dividend Yield* (John Wiley & Sons, \$49.95), says he first limits his search to companies with market values of at least \$1 billion, since larger companies tend to be more stable. Next, he focuses on stocks yielding more than the market overall—now about 1.6% for the Standard & Poor's 500-stock index—and more than they have historically. Higher relative dividend yields imply lower relative share prices, a disarmingly easy way of finding potentially undervalued stocks. With the market way off its high, there are plenty more of those now than there were in June.

The process has led Spare to take big positions in such companies as GTE, J.C. Penney, and Eastman Chemical. More recently, he has been attracted to

3M, which pays annual dividends of \$2.20 a share. With 3M selling at \$75 a share, that's a yield of over 2.9%—far higher than the market overall and a bit more than the company's average yield of 2.8% over the past five years. "Is the company in good shape?" asks Spare. "Yeah, it's the same company it has always been. Has the stock been neglected? Yeah."

With these broad guidelines in mind, we went looking for dividend-paying stocks that might prove to be good investments. Using StockQuest software, available free at Market Guide's Web site (www.marketguide.com), we screened the database of 9,211 companies for U.S. stocks with prices of at least \$5 a share, market values of at least \$1 billion, and average annual dividend growth of at least 5%.

We set a minimum of 3.2% for yields and an arbitrary maximum of 4.5%. That kept

Making the Cut

	PRICE*	12-MO. HIGH	12-MO. LOW	CURRENT YIELD	5-YR. AVG. YIELD
ALLEGHENY TELEDYNE	\$19.25	\$29.88	\$14.00	3.4%	2.6%
CONSOLIDATED PAPERS	23.50	35.06	24.13	3.7	3.2
CUMMINS ENGINE	28.44	82.50	29.19	3.8	1.9
HERCULES	29.75	51.38	24.63	3.7	1.9
INTL. FLAVORS & FRAGRANCES	34.31	51.88	32.06	4.3	2.8
KERR-McGEE	44.75	73.19	38.00	4.0	2.9
PEOPLE'S BANK	19.78	41.50	19.06	4.4	3.1
PHELPS DODGE	51.94	79.81	43.88	3.9	3.0
ROUSE	23.38	35.69	24.31	4.7	3.4
TCF FINANCIAL	17.06	37.25	18.75	3.9	2.4
UNITRIN	61.00	74.13	55.56	4.2	3.8
WESTVACO	24.56	37.50	21.00	3.6	3.0

*OC1 9

DATA: MARKET GUIDE INC., TELESKAN INC., YAHOO! FINANCE, BUSINESS WEEK

list to a manageable size knocked out most utilities, real estate companies, and occasionally high-yielding stocks that otherwise might have dominated the list. Finally, we excluded any stocks owned by officers, directors, and insiders on the theory they're less likely to cut income stream benefit from the result. A list of 20 companies, which we trimmed for a variety of reasons. Finally, we checked to see whether each stock's yield

was higher than its average for the past five years. While many Web sites and such print resources as *Value Line Investment Survey* provide a stock's year-by-year yield history, you can save time by plucking the five-year average yield from the free "Corporate Profile" section of Telescan's Wall Street City

Kerr-McGee; copper miner Phelps Dodge, and four manufacturers: Allegheny Technology, Cummins Engine, Hercules, and International Flavors & Fragrances (table). There's no way of knowing whether all are winners, but the list makes a good field for further prospecting.

Spare suggests looking

dends. The higher, the better. Anything under one you should see as a warning sign.

Even if a company's financial picture has dimmed, you shouldn't exclude it immediately. "We know stocks are most attractive when there is some deterioration occurring" on the balance sheet, Spare says. You should be

able to diversify away the risk of a company cutting its dividend by investing across different industries but buying shares in no more than, say, two dozen companies.

If you're not prepared to do the research yourself, use the challenge of finding good dividend-paying stocks as a way to test a full-service broker. Describe the kind of stocks you're looking for—those with market values of \$5 billion or more, say, and yields at least 50% above their historic average—and see what kind of list that generates. Then make the broker defend the safety of the stocks' payouts to win your orders.

Another way to invest in dividend-paying stocks is through a mutual fund. Among several recommended by Lisanti and Tighe are Tri-Continental, a large closed-end fund yielding 2.2%; AARP Growth & Income, which in the past year yielded 2.2%; Lexington Corporate Leaders (4.4%), and T. Rowe Price Dividend Growth (2.4%). All have lost less than the S&P 500 since its July peak. For the T. Rowe Price fund, Stromberg says he has been buying shares in banking company First Union, which recently yielded 3.8%, and British conglomerate Tomkins, at over 5%. People who are looking for a "high-beta, jackrabbit approach" to investing should steer clear of his fund, Stromberg says. "This is the tortoise strategy"—one that offers protection at times when you feel like pulling in your head and taking cover. *Robert Barker*

INVESTING One pro's advice: Find proven companies when they're out of favor—and forget you own them

site, www.wallstreetcity.com.

Among the dozen survivors are a pair of paper makers, Consolidated Papers and Westvaco; a few banking companies, TCF Financial and People's Bank; an insurer, Unitrin; a real estate developer, Rouse; an energy company,

carefully at the strength of the company's cash flow—that, after all, is the source of dividend payments—and its "dividend coverage." That's the ratio of cash earnings left after a company meets all other obligations to the total amount a company pays out in divi-



COMMENTARY

By Robert Barker

FUND FEES ARE RISING. WHO'S TO BLAME?



When your mutual fund was soaring 20% or 30% a year, did you care whether its expense ratio was higher than it should have been? Probably not. But as investors open statements and see the bear's paw, which in the past quarter slashed the average stock fund's value by 15%, the ever-rising fees will grate. Why pay extra to a manager who's making you poorer?

In the industry's view, the complaint that average fund expenses keep rising when economies of scale should send them falling doesn't give the whole story. Investment Company Institute President Matthew Fink on Sept. 29 told a congressional subcommittee: "The average shareholder account is in a mutual fund whose annual fees are 36% lower than the simple industry average.... This indicates that the market readily enables investors to own lower-cost mutual funds."

What Fink said is true as far as it goes. Yet it skirts the key question: What about those unlucky investors who pay higher-than-average expenses? Who's looking out for them? This wouldn't matter if the relationship of

Directors should represent investors' interests—and that includes keeping costs down

investor to mutual fund were akin to, say, a bank customer to a checking account. A fund investor, however, is not a customer but an owner, with say over how the fund should be run—a crucial distinction made explicit in the law. Also spelled out is the protection a fund's investor-owners are supposed to receive from independent directors who sit on every fund's board. Neither paid by nor otherwise obliged to the investment adviser, the directors have a fiduciary duty only to the fund's investors and not to Fidelity, Vanguard, or any other fund company. If expenses are too high, it's the independent directors who have failed.

Too few investment pros, let alone individuals, appreciate this difference. So here's a modest proposal: Fund companies should cast a brighter spotlight on the role of independent directors. Inform investors

better about who the directors are and how they can be contacted. Explain their responsibilities. Disclose more often how much they earn and how many fund shares they own.

Not many investors understand how fees are set, much less to whom they should complain. Funds must disclose directors' salary data only in an annual "Statement of Additional Information," an exotic document every investor is entitled to, but few know to ask for. Why not describe the directors' role, list them, and detail how they may be contacted in the prospectus everyone gets?

Whether a director owns shares in a fund can be found only in proxy statements funds issue irregularly, and then only if the directors as a group own more than 1%. Years can go by between proxies. Instead, why not report that data more often, perhaps in the prospectus?

Better disclosure entails a cost that must be weighed against the benefits, of course.

"There are a million things a million different people would like to see in a fund's prospectus," the ICI's Fink notes. But few are more important than specifying who speaks for the fund owners and how they might serve their fellows. That's the essence of representative democracy, and it can be achieved at no real cost. Data on directors now is disclosed only "if you can follow the treasure map and find the secret answer," notes Harold Evensky, a financial planner in Coral Gables, Fla., who also testified before Congress.

Don Phillips, president of the investment-research firm Morningstar, thinks fund directors do keep the industry close to the straight and narrow. "But," he says, "it's hard to argue that driving costs down is a preeminent" concern of theirs. Tightening the tie between those of us who own funds and our director-representatives can only help to put expenses near the top of the agenda.

Senior Writer Barker writes on mutual funds from Melbourne Beach, Fla.

EXPENSES: UP, UP, AND AWAY

AVERAGE EXPENSE RATIO*



1981 1998
U.S. DIVERSIFIED STOCK FUND
DATA: MORNINGSTAR

OUT BY A MEDICARE HMO?

much for the
edicare managed-
e honeymoon.
ne Jan. 1, more

400,000 elderly Ameri-
will get the boot from
health maintenance or-
zation. This mass aban-
ment is a function of stark
omics: Many Medicare
s simply aren't making
ey. It's also about poli-
-insurers want Congress
ange the rules in their

ose Medicare recipients
high and dry will have
ustle to find new health
ance. For many, it won't
asy to get comparable
fits at the same price.
re guaranteed the same
mal coverage as every-
else over 65—but nothing
e. And your old HMO is
ly required to help you
alternatives—but not to
pay for them.

PIER PLANS. In all but a
areas where HMOs have
ed altogether, you—or
older family members—
enroll in a new man-
-care plan. Your current
will send a list of
able plans by Nov. 2. By
date, too, Medicare vows
ost detailed comparisons
HMOs on the "Medicare
pare" section of its



Web site (www.medicare.gov).

Any Medicare HMO operat-
ing in your county is obliged
to accept anyone who applies
within 63 days of Jan. 1, with
immediate, full coverage of
any preexisting medical con-
ditions. Most likely, the bene-
fits will be similar to those
of your old plan. There's a
good chance it will cost more,
though, in the form of higher
premiums or co-payments—
the fees charged each time
you visit a doctor or get a
prescription filled. Your old
HMO pulled out for a reason,
after all: It wasn't getting
enough money to cover costs.

Before picking a plan, look
closely at enrollment materi-
als. Are your physicians in
the new HMO's network? If
not, you'll have to switch doc-
tors. Then, determine "what
constraints are there, med-

ical and financial" says Diane
Archer, director of the
Medicare Rights Center.
Some HMOs, for example, cov-
er an unlimited amount of
drugs. But more plans are
charging co-payments of \$10
or more per pre-
scription and
capping annual drug claims
at \$1,000 or lower. Above
that, you pay the bills.

If the extra expenses are
steep enough, or if your doc-
tor isn't in the network, con-
sider going to traditional fee-
for-service Medicare. If you
do nothing by Jan. 1, you'll
be enrolled automatically in
Medicare Part A, the manda-
tory plan that covers most
hospital expenses. Part B,
which is optional and costs
\$43.80 a month, pays 80% of
most doctors' charges. But
both parts together don't cov-

er as much as HMOs do. Their
deductibles and 20% co-pay-
ments will add up quickly if
you're seriously ill. So to
match the security of your
old HMO plan, you'll need a
supplemental Medigap policy.

The government guarantees
that any Medicare recipient
dropped by an HMO can buy
four of the 10 standard Medi-
gap policies from an insurer
for the same price as anyone
else—again, regardless of
medical history. The catch:
The remaining six, including
those that cover drugs, can
turn down applicants for any
reason. Also, supplemental
policies can be pricey—from
\$40 a month for the most ba-
sic, which covers the remain-
ing 20% of doctors' bills, to
up to \$260 for a deluxe plan
that includes drug benefits
and at-home care. That's a
reason many seniors flocked
to HMOs in the first place.

Should you make the
switch? True, managed-care
plans' benefits are superior to
traditional Medicare, given the
cost. Yet many consumer ad-

HEALTH

vocates fear that
this year's wave
of HMO pullouts portends more
dislocation to come. Unless
Congress authorizes higher
payments to insurers—an iffy
prospect—HMOs likely will
continue to raise costs to
members while scaling back
benefits. "The most important
lesson from this is that senior
citizens should be extremely
cautious about opting into
managed care," says Ron Pol-
lack, executive director of the
Families USA Foundation, a
health policy group. Better to
wait, perhaps, until the dust
settles. *Keith Hammonds*

Options for the HMO-less

your Medicare HMO
dropping you, fed-
law offers some
protections—with
important catches.

COMMUNICATIONS

Your old insurer is required
to help you find new cover-
age—but not to help pay
for it. It must send you
materials by Nov. 2
describing alternative plans
and their benefits.

SWITCHING HMOs

If other managed-care
insurers are operating in

your area, they're required
to take you on, even if
you're ill. But they may
offer fewer benefits, at
higher cost.

THE FALLBACK

If you do nothing, you'll be
enrolled automatically in
Medicare Part A, which
covers most hospital bills
but not doctors' services.

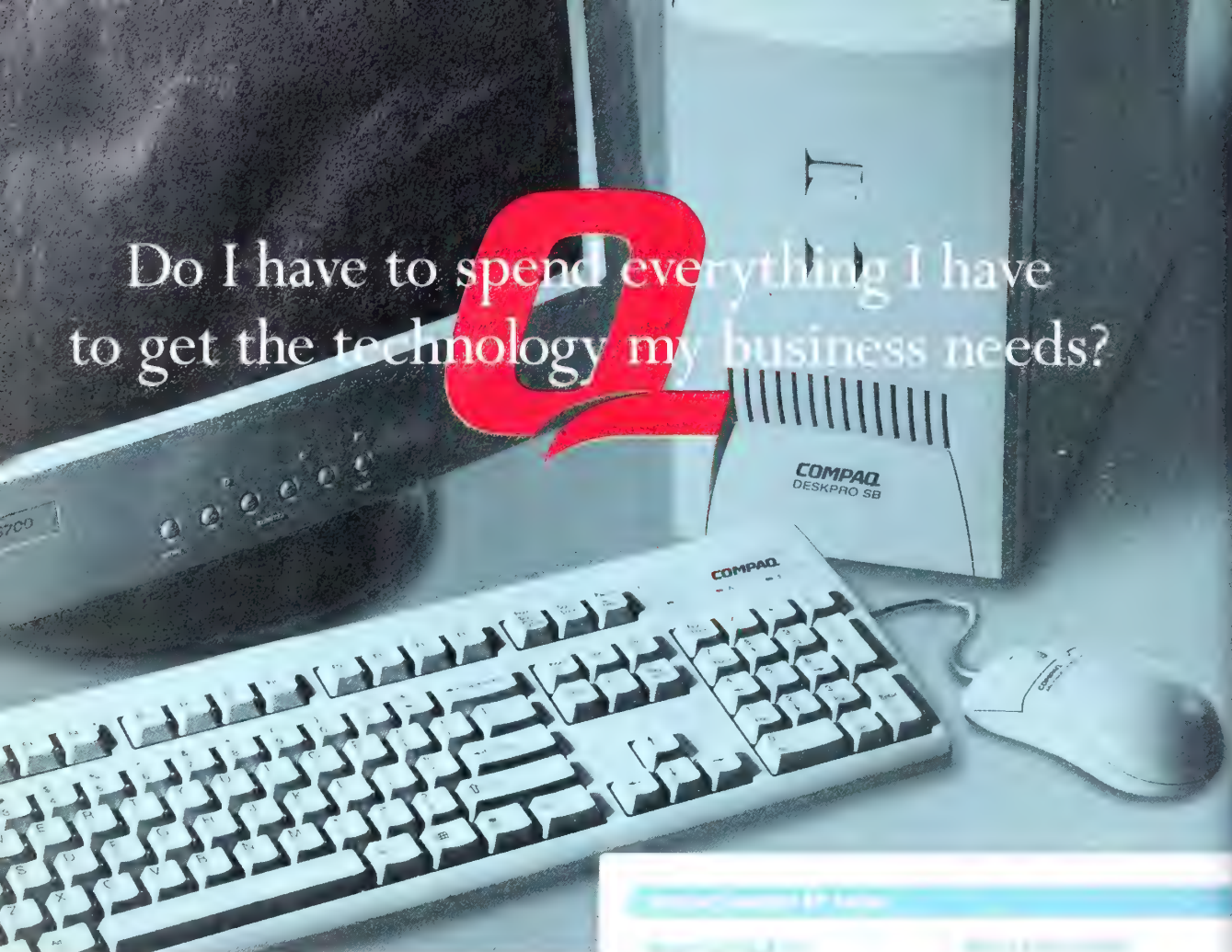
SUPPLEMENTAL COVERAGE

If you choose traditional
Medicare, the government
requires that private
Medigap insurance compa-
nies sell you a policy.
However, you're not
guaranteed coverage under
the high-end plans.

DATA: HEALTH CARE FINANCING ADMINISTRATION



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to get the technology my business needs?



Not when you order direct from Compaq. With products like the Compaq Deskpro EP Small Business Series of desktops, and the Compaq Armada Small Business Series of notebooks. They both come pre-installed with Microsoft® Office 97 Small Business Edition. And Compaq Small Business servers, equipped with Microsoft BackOffice® Small Business Server, give you the most technology for your money. Order by calling us directly or visiting our website. More technology and more ways to get it.

Microsoft

\$1,259*

Leasing price: \$42/Month¹

- Intel® Celeron™ Processor 300A MHz
- 4.3 GB* SMART II Hard Drive
- 32 MB SDRAM
- Compaq S700 17" (15.7" viewable) monitor
- Matrox MGA AGP Graphics
- Towerable chassis converts from desktop to minitower
- 3-year limited warranty²

\$2,239*

Leasing price: \$77/Month¹

- Intel Pentium™ II Processor 450 MHz
- 10 GB* SMART II Hard Drive
- 64 MB SDRAM
- Compaq S700 17" (15.7" viewable) monitor
- Matrox Millennium AGP Graphics with 8 MB VRAM
- 32X Max* CD-ROM
- Towerable chassis converts from desktop to minitower
- 3-year limited warranty²

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Armada Notebooks

Options

1573

\$599*

Leasing price: \$54/Month¹

- Intel Pentium Processor
- MMX™ Technology 233 MHz
- 2.4 GB SMART Hard Drive
- 32 MB SDRAM
- Expandable to 96 MB
- 15" STN SVGA display
- 24X Max³ CD-ROM
- K56flex modem⁴
- Integrated AC Adapter
- Battery
- 1-year limited warranty⁷

Armada 1700

\$2,999*

Leasing price: \$101/Month¹

- Mobile Intel Pentium II Processor 266 MHz
- 4.0 GB² SMART Hard Drive
- 32 MB SDRAM (expandable to 160 MB)
- 13.3" CTFT (1024 x 768) display
- 24X Max³ CD-ROM, optional DVD
- K56flex modem⁴
- Integrated AC Adapter
- Multibay design
- 1-year limited warranty⁷

Armada 3500

\$3,299*

Leasing price: \$111/month¹

- Mobile Intel Pentium II Processor 266 MHz
- 4.1 GB² SMART Hard Drive
- 32 MB RAM (expandable to 160 MB)
- 12.1" CTFT SVGA display
- 512 KB L2 Cache
- Optional CD-ROM or DVD via Mobile Expansion Unit
- 4.4 lbs. and 1.3" thin
- Magnesium display for durability
- 3-year limited warranty⁷

Armada 1573:

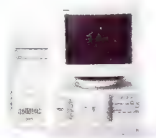
- Convenience Base (pass-through): **\$189***
- Additional Li-Ion battery: **\$189***

Armada 1700:

- Compaq Value Case: **\$49***
- 32 MB Memory Module: **\$95***

Armada 3500:

- Mobile Expansion Unit 24X Max³ CD: **\$199***
- Mobile Expansion Unit with DVD: **\$399***
- Additional Li-Ion battery: **\$209***



Small Business Solutions

Options

SB

\$499*

Leasing price: \$84/Month¹

- Intel Pentium Processor with MMX™ Technology 233 MHz
- 2.4 GB SMART Hard Drive
- 32 MB SDRAM
- 15" CTFT SVGA display
- Integrated 56K modem⁴, 24X CD-ROM, and AC Adapter
- Microsoft Office 97 Business Edition⁵
- Free Internet access through GTE⁶
- 1-year limited warranty⁷

Deskpro EP 6300X/4300/CDSM

\$1,699*

Leasing price: \$57/Month¹

- Intel Pentium II Processor 300 MHz
- 4.3 GB² SMART II Ultra ATA Hard Drive
- 32 MB SDRAM
- S700 Color Monitor
- ATI RAGE IIC AGP 64-bit Graphics Controller with 2 MB VRAM
- 24X Max³ CD-ROM
- 56K Data/Fax modem⁴
- Microsoft Office 97 Small Business Edition
- 3-year limited warranty⁷

ProSignia 200 6/300

\$4,719*

Leasing price: \$157/Month¹

- Intel Pentium II Processor 300 MHz
- 4.3 GB² Wide-Ultra SCSI-3 hard disk
- 64 MB ECC Memory (upgradable to 384 MB)
- 4/8 GB SLR enterprise-class tape drive
- Microsoft BackOffice⁵
- Insight Agent Events Notification Tool detects potential server issues
- 3-year on-site limited warranty⁷

Deskpro EP Series:

- Additional 32 MB SDRAM Memory: **\$99***
- Upgrade to Compaq 19" monitor: **\$220***
- SuperDisk LS-120 Drive: **\$119***
- Compaq C-Series 810 Handheld: **\$499***

Armada SB:

- Armada 1700/3500 Convenience Base (pass-through): **\$189***
- Additional Li-Ion battery: **\$195***

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October 26, 1998

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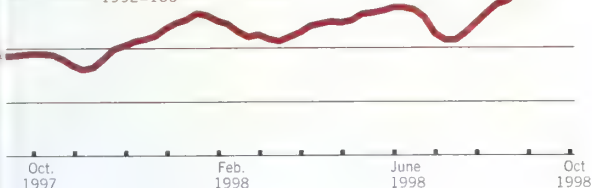
Malaysia Airlines
PSA Corp Ltd
China External Trade
Development Council

Business Week Index

PRODUCTION INDEX

Change from last week: 0.4%
Change from last year: 5.0%

PRODUCTION INDEX
Oct. 3=136.1
1992=100



production index continued to fall in the week ended Oct. 3. The averaged index dipped 0.2%, to 135.3, from 135.6 a week ago. Our seasonally adjusted figures show auto production down 6.3%, oil down 6.2%, down 0.4%, and rail freight down 0.3%. But even though those components were down this week, the Association of American Railroads pointed that freight traffic, including both automotive and coal, was up for quarter. Output of steel, trucks, electricity, and lumber rose.

Production index copyright 1998 by The McGraw-Hill Companies

ADING INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STOCK PRICES (10/9) S&P 500	984.39	1002.60	1.8
CORPORATE BOND YIELD, Aaa (10/9)	6.55%	6.12%	-7.6
KEY SUPPLY, M2 (9/28) billions	\$4,303.6	\$4,308.0r	8.1
UNEMPLOYMENT (10/2) thous	300	289	-2.6
MORTGAGE APPLICATIONS, PURCHASE (10/9)	343.1	304.0	46.2
MORTGAGE APPLICATIONS, REFINANCE (10/9)	4,389.1	3,253.1	419.1

Sources: Standard & Poor's, Moody's, Federal Reserve, Labor Dept., Mortgage Bankers Assn. (Index: March 16, 1990=100)

INTEREST RATES

	LATEST WEEK	WEEK AGO	YEAR AGO
FEDERAL FUNDS (10/13)	5.40%	4.65%	5.61%
COMMERCIAL PAPER (10/13) 3-month	5.11	5.10	5.53
CERTIFICATES OF DEPOSIT (10/14) 3-month	5.30	5.31	5.65
FIXED RATE MORTGAGE (10/9) 30-year	6.70	6.68	7.46
ADJUSTABLE MORTGAGE (10/9) one-year	5.53	5.60	5.73
REVERSE MORTGAGE (10/9)	8.25	8.25	8.50

Sources: Federal Reserve, HSH Associates, Bloomberg Financial Markets

Seasonally adjusted data in the production indicators are seasonally adjusted in computing the BW index (chart); other components (estimated and not listed) include machinery and defense equipment. 1=Western Wood Products Assn. 2=Southern Forest Products Assn. 3=Free market value NA=Not available r=revised NM=Not meaningful

PRODUCTION INDICATORS

	LATEST WEEK	WEEK AGO	YEARLY % CHG
STEEL (10/10) thous. of net tons	1,893	1,969#	-13.0
AUTOS (10/10) units	127,290	126,545r#	2.5
TRUCKS (10/10) units	140,298	140,932r#	3.3
ELECTRIC POWER (10/10) millions of kilowatt-hrs.	63,058	67,849#	-2.4
CRUDE-OIL REFINING (10/10) thous. of bbl./day	NA	13,653#	NA
COAL (10/3) thous. of net tons	22,305#	22,628	6.2
LUMBER (10/3) millions of ft.	489.9#	488.9	2.8
RAIL FREIGHT (10/3) billions of ton-miles	27.7#	27.6	4.1

Sources: American Iron & Steel Institute, Ward's Automotive Reports, Edison Electric Institute, American Petroleum Institute, Energy Dept., WPPAI, SFPA2, Association of American Railroads

PRICES

	LATEST WEEK	WEEK AGO	YEARLY % CHG
GOLD (10/14) \$/troy oz.	295.300	298.000	-9.6
STEEL SCRAP (10/13) #1 heavy, \$/ton	85.50	85.50	-38.7
COPPER (10/9) ¢/lb.	75.5	78.7	-22.0
ALUMINUM (10/9) ¢/lb.	63.5	63.5	-19.1
COTTON (10/9) strict low middling 1-1/16 in., ¢/lb.	70.85	69.95	2.2
OIL (10/13) \$/bbl.	14.02	15.30	-32.0
CRB FOODSTUFFS (10/13) 1967=100	224.10	222.04	-8.1
CRB RAW INDUSTRIALS (10/13) 1967=100	275.10	276.06	-17.8

Sources: London Wednesday final setting, Chicago market, Metals Week, Memphis market, NYMEX, Commodity Research Bureau

FOREIGN EXCHANGE

	LATEST WEEK	WEEK AGO	YEAR AGO
JAPANESE YEN (10/14)	119.34	122.85	121.22
GERMAN MARK (10/14)	1.64	1.61	1.75
BRITISH POUND (10/14)	1.71	1.70	1.62
FRENCH FRANC (10/14)	5.50	5.40	5.86
ITALIAN LIRA (10/14)	1623.5	1593.0	1709.0
CANADIAN DOLLAR (10/14)	1.55	1.52	1.39
MEXICAN PESO (10/14)	10.185	10.180	7.732
TRADE-WEIGHTED DOLLAR INDEX (10/14)	106.3	106.6	105.7

Sources: Major New York banks. Currencies expressed in units per U.S. dollar, except for British pound in dollars. Trade-weighted dollar via J.P. Morgan.

THE WEEK AHEAD

INTERNATIONAL TRADE

Monday, Oct. 20, 8:30 a.m. EDT ► The U.S. deficit for goods and services probably rose to \$15 billion in August, projects median forecast of economists surveyed by Standard & Poor's MMS, a division of The McGraw-Hill Companies. In July, the deficit had hit a peak of \$15.8 billion in May. Imports, which have risen in only one month so far in 1998, probably dropped in August as the Asian financial crisis spread to other nations. Imports, up just 0.8% in July, probably increased. Asian collapse plus a strong dollar has sharply curtailed U.S. exports. As a result, net trade subtracted almost three per-

centage points from real gross domestic product growth in the first half, and it is likely to be a further drag on the economy in the second half as well.

HOUSING STARTS

Wednesday, Oct. 21, 8:30 a.m. EDT ► Housing starts probably slipped to an annual rate of 1.6 million in September, from 1.61 million in August, says the S&P MMS survey. That's suggested by a drop in construction jobs last month and a small decline in the Housing Market Index compiled by the National Association of Home Builders. Even so, housing remains one of the strongest sectors of the economy. Lower mortgage rates still make home ownership quite attractive.

FEDERAL BUDGET

Thursday, Oct. 22, 2 p.m. EDT ► The U.S. Treasury will probably report a surplus of about \$40 billion in September, says the S&P MMS median forecast. That's smaller than the \$49.9 billion reported in September, 1997. The expected monthly windfall, however, means that for fiscal 1998, which ended on Sept. 30, the federal government posted a surplus of about \$70 billion. That's exactly the figure publicized by the White House. Tax receipts from capital gains helped to boost the black ink. But with equity prices falling since July, that tax windfall may not reappear this year. Congress and the White House are still hammering out a budget for fiscal 1999.

Index to Companies

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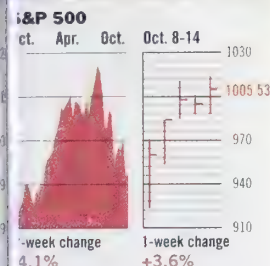
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Investment Figures of the Week

STOCKS



COMMENTARY

Another wild week in the markets. The dollar took center stage, plummeting against the yen on news of Japan's efforts to restructure its banking system. Bond yields also plunged, with the 30-year Treasury rising from 4.7% to 5.1% and ending the week at 5.03%. Tech stocks went on a tear as better-than-expected earnings from Intel helped assuage fears of over corporate profit growth. The NASDAQ Composite gained 3.6% for the week. The Dow Jones industrial average revisited 8000 on Oct. 12 before closing at 7968.8 on Oct. 14.

U.S. MARKETS	Latest	% change Week	% change Year
Dow Jones Industrials	7968.8	2.9	-1.1
NASDAQ Combined Composite	1541.0	5.4	-10.6
S&P MidCap 400	293.2	2.8	-13.5
S&P SmallCap 600	135.2	1.1	-29.4
S&P SuperComposite 1500	210.7	3.5	0.9

SECTORS	Latest	% change Week	% change Year
Bloomberg Information Age	338.6	4.4	11.4
S&P Financials	105.1	9.1	-8.8
S&P Utilities	259.1	-2.8	25.2
PSE Technology	304.5	7.2	-11.3

FOREIGN MARKETS	Latest	% change Week	% change Year
London (FT-SE 100)	5038.4	4.3	-4.3
Frankfurt (DAX)	4318.5	5.6	3.0
Tokyo (NIKKEI 225)	13,070.7	-5.5	-24.6
Hong Kong (Hang Seng)	8840.0	14.1	-34.0
Toronto (TSE 300)	5595.7	2.4	-21.5
Mexico City (IPC)	3595.4	6.5	-32.7

FUNDAMENTALS	Latest	Week ago	Year ago
S&P 500 Dividend Yield	1.60%	1.61%	1.56%
S&P 500 P/E Ratio (Last 12 mos.)	24.0	23.7	24.5
S&P 500 P/E Ratio (Next 12 mos.)*	19.3	19.0	19.2
First Call Earnings Surprise*	5.04%	9.05%	3.41%

TECHNICAL INDICATORS	Latest	Week ago	Reading
S&P 500 200-day average	1067.6	1066.6	Negative
Stocks above 200-day average	17.0%	19.0%	Positive
Options: Put/call ratio	0.80	0.80	Positive
Insiders: Vickers Sell/buy ratio	0.47	0.62	Positive

Data: Bloomberg Financial Markets; *First Call Corp.

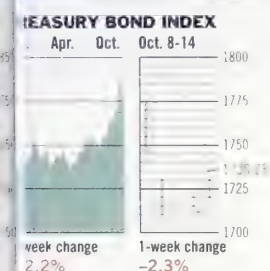
BEST-PERFORMING GROUPS	Last month%	Last 12 months%
Household Products	13.5	Drug Chains 55.5
Steel	12.4	Specialty Appr. Retailers 45.8
Tobacco	11.2	Genl. Merchandise Chains 44.7
Forest Products	10.1	Long-Dist. Telecomms. 38.4
Regional Telephone Cos.	8.8	Regional Telephone Cos. 36.3

WORST-PERFORMING GROUPS	Last month%	Last 12 months%
Metal & Glass Containers	-23.1	Oil & Gas Drilling -66.8
Homebuilding	-21.5	Leisure Time -52.2
Oil & Gas Drilling	-18.4	Metals -48.4
Manufactured Housing	-16.4	Oil-Well Equip. & Svcs. -46.7
Pollution Control	-16.1	Machine Tools -43.1

BLOOMBERG MONEY FLOW ANALYSIS

Rebound ahead? Stocks with most significant buying on price weakness	Price	1-month change
Citigroup	79 13/16	-21 3/16
IBM	128 7/16	-15 1/16
Intel	83 9/16	-2 1/4
Merck	130 3/4	-1 1/4
America Online	92 1/4	-5 3/4
Pfizer	87 1/2	-15 3/4
Decline ahead? Stocks with most significant selling on price strength	Price	1-month change
Tellabs	39 7/16	1 1/2
Qwest Communications Intl.	30	1 3/16
Starbucks	34 7/8	2 19/16
CMG Information Services	41 1/2	1/4
Adobe Systems	33 7/8	5 1/8
Goodyear Tire & Rubber	49	1/4

INTEREST RATES



Bloomberg Financial Markets

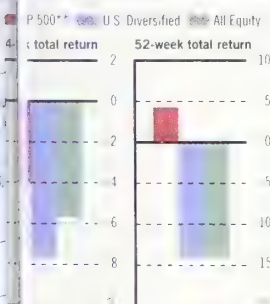
KEY RATES	Latest	Week	Year
MONEY MARKET FUNDS	4.97	5.02	5.14
90-DAY TREASURY BILLS	3.99	4.15	5.06
6-MONTH BANK CDS	4.64	4.72	5.18
1-YEAR TREASURY BILLS	4.17	4.23	5.52
10-YEAR TREASURY NOTES	4.61	4.34	6.10
30-YEAR TREASURY BONDS	5.03	4.83	6.39
LONG-TERM AA INDUSTRIALS	6.27	5.92	6.86
LONG-TERM BBB INDUSTRIALS	6.94	6.77	7.23
LONG-TERM AA TELEPHONES	6.75	6.38	7.19

BLOOMBERG MUNI YIELD EQUIVALENTS

Taxable equivalent yields on AAA-rated, tax-exempt municipal bonds, assuming a 31% federal tax rate.

	10-yr. bond Latest week	Last week	30-yr. bond Latest week	Last week
GENERAL OBLIGATIONS	4.02%	3.95%	4.71%	4.63%
PERCENT OF TREASURIES	87.26	89.99	93.64	95.28
TAXABLE EQUIVALENT	5.83	5.72	6.83	6.71
INSURED REVENUE BONDS	4.17	4.08	4.94	4.83
PERCENT OF TREASURIES	90.52	92.95	98.22	99.39
TAXABLE EQUIVALENT	6.04	5.91	7.16	7.00

MUTUAL FUNDS



Morningstar, Inc.

EQUITY FUNDS

Leaders	Laggards
Four-week total return	Four-week total return
Newport Tiger B 22.5	American Heritage -24.1
Newport Tiger Cub A 22.3	Oberweis Mid-Cap -20.5
Newport Greater China A 20.8	Profunds UltraOTC Investor -19.8
Montgomery Emerg. Asia R 19.7	Federated Aggress. Grth. B -19.5
Matthews Korea I 19.2	Texas Capital Val. & Grth. -19.5
Leaders	Laggards
52-week total return	52-week total return
Smith Barney Telecomm. Inc. 41.7	Lexington Troika Russia -89.1
Berger Balanced 35.9	Frontier Equity -72.4
Icon Telecomms. & Utilities 31.1	Dreyfus Aggressive Growth -64.9
Galaxy II Util. Idx. Retail 28.7	Vontobel Eastern Europ. Eq. -64.2
Principal Utilities A 28.5	American Heritage -63.7

EQUITY FUND CATEGORIES

Leaders	Laggards
Four-week total return	Four-week total return
Precious Metals 12.1	Small-cap Growth -13.0
Pacific/Asia ex-Japan 11.2	Small-cap Blend -11.7
Diversified Pacific/Asia 3.3	Mid-cap Growth -10.8
Latin America 1.4	Small-cap Value -10.1
Utilities 1.0	Technology -10.1
Leaders	Laggards
52-week total return	52-week total return
Utilities 14.4	Latin America -51.3
Domestic Hybrid -1.4	Diversified Emerging Mkts. -48.1
Large-cap Blend -2.7	Pacific/Asia ex-Japan -43.7
Large-cap Growth -3.3	Natural Resources -36.4
International Hybrid -4.1	Diversified Pacific/Asia -36.1

are as of market close Wednesday, Oct. 14, 1998, unless otherwise indicated. Industry include S&P 500 companies only. Fundamentals, technical indicators, Bloomberg mon-

ey flow analysis, and mutual fund returns are as of Oct. 13. For a more detailed explanation, write to us or E-mail figures@businessweek.com. NA=Not available **Vanguard Index 500 Fund

THE AGE OF UNCERTAINTY

In the blink of a summer's eye, the psychology in America has changed totally. People suddenly don't know what to think about the economy, their investments, or their future. Before July, the U.S. had economic nirvana. Now confusion reigns. Volatility dominates markets. Hedge funds blow up. Deflation looms. The Asian contagion spreads. Russia defaults. The dollar plummets. CEOs worry. And Washington fiddles with impeachment. Yet the economy still feels pretty strong. So what is really going on out there?

Blame it on the fog—not the weather, but a surprising confluence of events that is masking the true fundamentals of the global economy, making life uncertain and people anxious. Is the U.S. heading for serious economic trouble? Maybe. But it's also possible that the current gloom is overblown, that Asia is beginning to find its legs, and that the impending U.S. slowdown will be a soft landing instead of a hard thud. There are five murky situations to watch that will determine whether the global economy slides into a synchronized recession or bottoms out and begins to grow again.

■ **The yen turnaround.** The yen soared an amazing 20% against the dollar in the space of three days, reversing its long slide. A stronger yen is a tonic for Asia's malaise, making Pacific Rim exports more competitive, taking the heat off China to devalue, and boosting the buying power of Japanese consumers. A lower dollar also cuts the cost of oil to Asia and provides U.S. multinationals with a profits fillip. But is the yen rebound real or a technical unwinding of highly leveraged hedge-fund positions? Will the dollar shoot back up to 130, 140, or even 150 yen by Christmas? Stay tuned.

■ **The Japanese bank bailout.** One of the longest-running soap operas appears to be ending. The politicians are throwing \$600 billion into the rescue, equivalent to nearly all of Japan's bad loans. If it works, liquidity would start flowing, and businesses would begin growing again, pulling in imports.

But is the deal for real? Eight years of shadow plays and false starts feed the skepticism. This time, it could be different. Stay tuned.

■ **Monetary policy.** The Federal Reserve recently cut U.S. short-term interest rates by a grudging 25 basis points when the shaky markets expected 50. Then the German Bundesbank flip-flopped on easing, finally saying "Nein." With economic growth falling around the globe, lower interest rates are critical. But the U.S. and Europe can't agree on a coordinated easing. Yet piecemeal, interest rates are being cut—in Britain, Canada, Spain, China, Japan, Ireland, and Portugal. This stealth wave of rate cuts could put a floor under the recession. But is it enough? And will Fed Chairman Alan Greenspan, so unnerved by market developments ("I've never seen anything like this"), take U.S. rates down by another 75 basis points sooner rather than later? Stay tuned.

■ **The LTCM bailout.** Nothing surprised the markets more than the sudden near-death of this hedge fund. Under the unseeing eyes of the public, regulators, investors, and Washington politicians, Long-Term Capital Management borrowed huge sums from clueless banks and leveraged its capital to unheard-of levels before it crashed and burned, threatening the entire financial system. Are the big banks and Wall Street investment firms now so wounded they will stop lending, thereby strangling the U.S. economy? Stay tuned.

■ **The Asian contagion.** Conventional wisdom holds that Asia is in freefall. But there are signs that emerging markets may be bottoming out. Trade surpluses for Indonesia, Thailand, Korea, and Malaysia are soaring. Interest rates are falling sharply. Stock markets, including Hong Kong's, are up 15% to 20%. Is this the turn? Are lower rates and a rising yen reliquefying Asia, reversing its decline? Stay tuned.

The greatest hopes and worst fears of economists are seldom realized. That is likely to be the case once again.

SCRAMBLED SIGNALS ON THE DIGITAL FRONT

Ready or not, here comes digital TV. On Nov. 1, 42 U.S. stations will begin broadcasting high-definition TV. They will usher in a new era of convergence, bringing together entertainment, computing, and telecommunications. The promise is exciting: sparkling screen resolution, TV interactivity, access to the Web, videoconferencing with mom and dad. You name it. But getting there may be messy. The lack of standards plaguing the cell-phone industry pales in comparison with the situation in the nascent digital-TV market. The longer cable operators, broadcasters, computer and equipment makers, and consumer-electronics giants delay establishing compatibility for consumer HDTV products, the longer it will take for digital TV to evolve into a popular industry.

Washington was right to get out of the way in the rush to HDTV. After all, Tokyo spent billions and came up with the wrong technology—analogue. U.S. companies shifted high-definition to digital, clearly the superior choice. But diverse players in the budding HDTV marketplace are creating complex incompatibilities. Cable companies and broadcasters, for example, use different "modulation" systems so cable boxes won't be able to display HDTV broadcasts that originate over the air. Some encoder boxes won't work with some digital sets. In time, the marketplace should shake much of this out. But the failure of companies involved in HDTV to cooperate early on will delay the successful evolution of the new industry. With HDTV in its infancy, there's still time to fix the

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